ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

RIBA, BANK INTEREST AND THE RATIONALE OF ITS PROHIBITION

Visiting Scholars' Research Series
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ISLAMIC DEVELOPMENT BANK
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RIBA, BANK INTEREST AND THE RATIONALE OF ITS PROHIBITION

Mohammad Nejatullah Siddiqi

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FOREWORD

The Visiting Scholars Program was introduced during 1413H as part of IRTI's multi-pronged efforts to develop Islamic economics and finance. The program aims at enabling external scholars to visit IRTI on short-term basis in order to carry out certain well-defined research task or project. We were fortunate to have Prof. Nejatullah Siddiqui last year who kindly accepted the invitation to come to IRTI under this program. A tangible benefit of his visit to IRTI is this book.

IRTI felt that there was a need to explain *riba*, bank interest and the rationale of its prohibition in modern terms to the general public and scholars who are unfamiliar with the developing field of Islamic banking and finance. Prof.Nejatullah Siddiqui also shared this feeling. He has therefore written this book with this perspective. Starting from *shariah* and economic reasons for prohibition of *riba* the book shows that this prohibition aims at preventing injustice and promoting fairness, equity and efficiency. It then covers the entire financial system, its various components as well as macro-monetary management, and highlights the impact of prohibition of *riba* along with alternative arrangements under Islamic system showing how the above objectives are achieved. The clear and succinct writing style of the author will help the reader gain understanding of the subject and the issues involved.

Acting Director

Islamic Research and Training Institute

PREFACE

What is *riba*? Why does Islam prohibit it? Is bank interest *riba*? How can we live without interest? This book tries to answer these and similar questions. I am aware of several learned authors doing the same in the past. I have tried not to repeat them as far as possible. Since some of the best works, like those of Abu Zahra and Maudoodi, were written before the spread of Islamic financial institutions, there was a need to enrich the discussion with lessons from the recent practice of Islamic banking and finance. I hope this book fulfills that need.

In doing this work, I had the benefit of discussions with Adam Biraima, Ausaf Ahmad, Habib Ahmed, Mabid Ali al-Jarhi, M. Fahim Khan, Mohamed Ali Elgari, Mohammad Anas Zarqa, Mohammad Obaidullah, Mohammad Umer Chapra, Munawar Iqbal, Naseerudin Khan, Omar Zuhair Hafiz, Osman Babikir, Salman Syed Ali and Tariqullah Khan. While I owe many a good points to them, none of them is responsible for any deficiencies that might remain in this work.

I have also had the fullest cooperation from the staff of the IDB library and from everybody in the Islamic Research and Training Institute, which hosted me as a visiting scholar to do this job. Thanks are due to the scholars whose comments on the outline were of great benefit to me. Thanks are also due to the two referees who looked at the completed manuscript and helped me in making important additions. Last but not the least, I owe special thanks to the President of the Islamic Development Bank, Dr. Ahmad Mohammad Ali, for facilitating my involvement with this project.

Like all human endeavors, this one too must have left many things to be desired. I will appreciate any feedback from the readers. I pray to Allah to accept the services of all those involved, including myself.

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RIBA, BANK INTEREST AND THE RATIONALE OF ITS PROHIBITION

INTRODUCTION

WHY THIS BOOK?

Muslims have always agreed that *riba* is prohibited. What constitutes *riba* has, however, been a subject evoking deliberation and debate over the centuries that followed the age of divine revelation. Not surprisingly, the practice has reflected the differences in interpretation. Yet the core idea, the prohibition relating to the additional payment demanded by giver of a money loan, has sustained itself in the imagination of Muslim peoples in all ages. Its avoidance in practice has, however, had a chequered career. It has ranged from strict adherence to conformity with some exceptions, made on the ground of necessity or because of living outside the lands ruled by Islam, to widespread violations under some stratagem or other. During the modern times with the system of money and banking based on interest, controversy surrounds bank interest, is it the *riba* prohibited in the Quran or is it not? The overwhelming majority of religious scholars and most of the laymen consider bank interest to be *riba* while a few scholars and a section of Muslim laymen think it is not. The issue has acquired political significance in recent times because of some Muslim countries' constitutional commitment to adhere to Islamic Law (*shariah*).

This book is a modest effort to clarify the issues involved. In the first chapter we put our subject of study in perspective by describing Islam's worldview and the purpose of laws in Islam. How the quest of fairness in the 'ordinary business of life' leads to a bunch of rules constraining individual freedom and guiding the state in its supervisory role is explained.

The second chapter focuses on the meaning of *riba* in the light of the relevant texts. Muslims' understanding of the concept and coverage of *riba* is traced through the ages till our own day. The effort by some to declare modern bank interest outside the scope of prohibited *riba* is put in historical perspective. After examining their arguments it is concluded that bank interest is *riba*.

The third chapter examines what the prohibition of bank interest would do to a modern economy. It explores the alternatives to interest based institutions in the light of the developments of interest-free Islamic banking theory and practice since the middle of the last century. It demonstrates that the economy can function smoothly without the institution of interest on the basis of Islamic finance.

The fourth chapter focuses on some distinguishing features of interest-free Islamic finance at the macro-economic level. It is argued that Islamic finance is conducive to greater stability and more efficiency than conventional finance. It is a fairer arrangement capable of leading human society to greater equity and higher growth.

The fifth chapter shows how Islamic finance meets certain special needs like government finances, finance for the consumers, microfinance, especially for the rural sector, and interest-free financial arrangements for Muslim minorities.

The sixth chapter deals with monetary policy and the problems arising out of changes in the purchasing power of money in the context of loans made in money. The seventh chapter concludes the study by summarizing the findings. A Bibliography followed by an Index completes the book.

CHAPTER 1

ISLAM AND ITS LAWS

In this chapter we provide a perspective for what is to come in the later chapters. These later chapters discuss a particular provision in Islamic law, the prohibition of *riba*. We have first to see what Islam is and what place Law has in it. The laws in Islam cover many aspects of life. For our study of a law relating to the economy we need to ask how economic life is perceived as an aspect of life in general and what are the goals of Islamic law relevant to this particular aspect of human life. Placing the prohibition of *riba* in the context of the goals of the *shariah* (Islamic law) will help us in the next task, the enquiry whether modern bank interest is included in the *riba* prohibited in Islam. This task is in fact taken up in detail in the next chapter as it involves going back to the relevant texts of Quran and *Sunnah* and their understanding by the scholars over the ages. In this chapter we confine ourselves to the general thrust of the laws relating to economic transactions in the context of the relevant goals of *shariah* whose focus is ensuring justice and fairness in social, economic and political relations, and survival with dignity for each and all. This makes us ask what is just and fair and how Islam mobilizes spirituality and morality too in order to realize justice and equity rather than rely exclusively on law. Lastly, we have to ponder how the social goals are to be achieved without endangering individual freedoms so crucial in Islam. In this context we go beyond law to philosophy, economic analysis and history, including recent history, to arrive at conclusions which can by their very nature be only tentative. It is referring back these conclusions to Islamic law and history that can give them somewhat greater credibility.

Tawheed

Islam's worldview inheres in *tawheed.* It is a relationship with the Only One that excludes a similar relationship with any one else. It is man's commitment to Allah making Him the only source of value. It implies emancipation and restoration of man's essential freedom from all other bondages. It envisages a particular relationship with environment as Allah's creation, neither to be feared nor revered, but looked upon as partners in living as Allah wills. The

consciousness that *tawheed* creates gives humans a sense of being equals. All human beings are equally free and independent of one another in their dependence on Allah. In passing through the divinely conducted test that is life all humans are invited to utilize the God-given faculties of observation, analysis, reasoning and judgment. The following verses from the Quran carry these messages home about the essential dignity and equality of human beings, about life being a test and about the need to think, observe and be aware of one's individual responsibility.

> Verily we have honored the children of Adam. We carry them on the land and the sea, and have made provision of good things for them, and have preferred them above many of those whom we created with a marked preferment. (17:70)[1]
>
> Blessed is He in whose hand is the Sovereignty, and He is able to do all things. Who has created life and death that He may try you, which of you is best in conduct; and He is the Mighty, the Forgiving.(67:1-2)
>
> He it is who has placed you as viceroys of the earth and has exalted some of you in rank above others, that He may try you by (the test of) that which He has given you. Lo! Your Lord is swift in prosecution, and Lo! He is Forgiving, Merciful. (6:165)
>
> Have they not pondered upon themselves? Allah created not the heavens and the earth, and that which is between them, save with truth and a destined end. But many of mankind are disbelievers in the meeting with their Lord. (30:8)
>
> Say (unto them, O Muhammad): I exhort you unto one thing only: That you awake, for Allah's sake, by twos and singly, and then reflect: There is no madness in your comrade. He is naught else than a warner unto you in face of a terrific doom. (34:46)
>
> And each one of them will come unto Him on the Day of Resurrection, alone. (19: 95)

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[1] All translations are from the Meaning of the Glorious Quran by Muhammad Marmaduke Pickthall, with slight linguistic adaptation to modern English. The numbers in parentheses are those of the surahs (chapters) followed by the verses.

From accountability follows the idea of trusteeship insofar as property is concerned.

> Believe in Allah and His messenger, and spend of that whereof He has made you trustees; and such of you as believe and spend (aright), theirs will be a great reward. (57:7)

It will have been noticed that every verse quoted above presumes that the individual human being, the addressee, is free to choose. The test that is life and individual accountability on the day of judgment make sense only with freedom. There is to be no coercion.

> There is no compulsion in religion. The right direction is henceforth distinct from error. And he who rejects false deities and believes in Allah has grasped a firm handhold, which will never break. Allah is Hearer, Knower. (2:256)

The picture is now emerging; the idea is to create an environment in which human beings are free to choose, having been informed about right and wrong, good and bad…. Those choosing the right path are then guided further on. Those failing to do so have time to learn and change. They are not coerced into conformity. But social order has to be maintained with a view to ensuring survival with dignity and for free choice to continue to be possible. This is where Law comes in.

***Shariah* and its Objectives**

Islamic law covers all aspects of life. For clarity of understanding one has to distinguish between laws related to *ibadat* (worship, prayer) and laws relating to *muamalat* (transactions, worldly affairs). We have also to distinguish between rules of conduct, injunctions, exhortations, etc. that are not legally enforced. Sometime there are gradations in a rule recommended in general but legally enforceable in certain circumstances. To put these categories in perspective one has to consider the relationship between law and morality.

Morality is the basic thing as it follows from the spirituality in religion like the existence of God, life after death, accountability, a feeling of equality with other human beings, a sense of shared creature-ness with all that is in the

environment, etc. This seems to be the rationale behind the Prophet's saying; "I have been sent to take good moral behaviour (*husn al-akhlaq*) to completion [perfection] (Malik, 1995, p.692)[#]…" Good moral behaviour follows naturally from *tawheed.* But there are vital individual and social interests that depend on good moral conduct, so all of it cannot be left to voluntary choice. A minimum of morality has to be enforced, especially when X's conduct affects Y's interests too. Unless that is done all freedom and choice will be threatened. Therein comes law. But by the very nature of this relationship between law and morality, the boundary line between the two has to be flexible. The crucial factors are information and a will to morality. The more relevant information people have and the higher the level of adherence to moral standards in a society the less legislation it may need, and vice versa. Also, one should never forget the organic relationship between law and morality as both together constitute the *shariah.*

With the above in mind it is time now to turn to *maqasid al-shariah,* the goals Islam seeks to achieve through the twin bodies of laws and morals.

Maqasid al-shari'ah

Though special attention to objectives of *shariah* as a subject of study dates from the fifth hijri century (eleventh century C.E) there are many texts in the Quran and *Sunnah* pointing towards them. Also, when the jurists in the first to fourth hijri centuries (seventh to tenth centuries C.E) discussed *maslaha* (benefits) and related concepts they were not far from what later came to be termed *maqasid* (objectives). It is advisable to quote some of the texts in Quran and *Sunnah* before we turn to Ghazali and Shatibi, the two towering figures in Islamic jurisprudence who paid special attention to the subject.

We single out two broad goals, growth (*tazkiyah)* and justice (*qist*) mentioned in the Quran.

> We verily sent Our messengers with clear proofs, and revealed with them the Scripture and the Balance, that mankind may observe right measure;…(57;25)[2]

[#] Mu'atta Imam Malik, tradition no:1677. Also see, Al- Bukhari, Al-Jami' al-Saheeh, *Kitab al-Adab, bab* (chapter) no: 39 entitled *Husn al-Khulq*….

[2] The Arabic word *qist*, in the above quoted verse, translated (by Muhammad Marmaduke Pickthall) as right measure, has been rendered as equity by Muhammad

Another verse emphasizes the same:

> Lo! Allah enjoins justice, and kindness and giving to kinsfolk and forbids lewdness and abomination and wickedness. He exhorts you in order that you may take heed. (16:90)

The concept of *tazkiyah* is wider than that of justice as it fully encompasses the individuality of a person before relations with other persons come into the picture, even though they too are included.

> Even as We have sent unto you a messenger from among you, who recites unto you Our revelations and causes you to grow in purity, and teaches you the Scripture and wisdom, and teaches you that which you know not. (2:151)

> Allah verily has shown grace to the believers by sending unto them a messenger of their own who recites unto them His revelations, and causes them to grow in purity, and teaches them the Scripture and wisdom; although before (he came to them) they were in flagrant error. (3:164)

The Quran also tells us that the *shariah* is characterized by leniency and softness rather than by harshness and toughness (in its injunctions given with a view to realizing its objectives).

> Allah desires for you ease; He desires not hardship for you… (2:185)

> And strive for Allah with the endeavor, which is His right. He has chosen you and has not laid upon you in religion any hardship (22:78)

> Allah tasks not a soul beyond its scope… (2:286)

> Allah would make the burden light for you, for man was created weak. (4:28)

> And be you kind as Allah has been kind to you, and seek not corruption in the earth. (27:77)

Asad and as justice by Abdullah Yusuf Ali. All convey the same sense, the message being that fairness in dealing with one another is what *shariah* seeks in human living.

The Prophet, peace be upon him, also emphasized this feature of Islam. He is reported to have said: 'Allah is kind and likes kindness…' (Abu Daud, *Kitab al-Adab, Bab fi'l Rifq*)

In the traditions from the Prophet we find extensions upon the above stated objectives to what are obviously necessary preconditions to their realization or corollaries to them. Some of these are mentioned in a supplication:

> Allah I ask your refuge from poverty, scarcity and ignominy.
> (Al-Bukhari, 1349H, p. 99)
> Allah I ask your refuge from hunger for it is the worst bedfellow.
> (Nasaie, *kitab al Isti'azah, bab al Isti'azah min al ju')*

By the time of Al-Ghazali (451-505/1055-1111), Principles of Islamic Jurisprudence (*usul al-fiqh*) was well established as a separate discipline. A discussion on the objectives of Islamic Law, *maqasid al-shariah,* belonged to this subject of study. Endorsing the generally accepted view that *shariah* sought to promote the welfare (*masalih*) of human beings—a view elaborated earlier by his teacher, Al-Juwaini (419-478/1028-1085)--- Ghazali noted that 'the objectives of *shariah* that relate to people are five: that is to protect their religion, life, reason, progeny and property, so whatever serves these five basics is *maslaha*'(Al-Ghazali, 1322H, Vol. 1, p.286). Among these, 'life' came first as the other objectives are meaningful only if one survives so as to function. Ghazali therefore was quick to note that 'bodily health, survival and availability of a minimum of clothing, housing and other supplies' were presumably necessary for these goals to be realized.

Shatibi (d.790/1388) discussed the subject in detail, giving *maslaha* a central place. He endorsed the list of five objectives given earlier by Ghazali, but did not give it much importance. More significantly, he had a perception that wealth (*mal*), last in Ghazali's list, could be a means to the realization of the other objectives mentioned in that list. (Al-Shatibi, n.d, Vol. 2, p. 127) Shatibi paid great attention to three levels of realisation for every goal of *shariah* or *maslaha*: absolutely necessary (*daruri*), needed (*haji*) and desirable for completion (*tahsini*).

Later scholars saw no reason to confine the objectives of *shariah* to this list, adding to it freedom, justice and personal dignity or honour (Al-Hasany, 1995, p.61). The most notable among these scholars is Ibn Taymiyah (661-728/1263-1328). Ibn Taymiyah averred that securing benefits (*manaf'*) for people and protecting them from harm (*madarr*) was the general objective under which the five objectives listed by some could be subsumed. (Ibn Taymiyah, 1983a, Vols. 4-5, pp. 174-75) Ibn al-Qayyim (691-751/1292-1350), while discussing how new situations demanding fresh legislation (*hukm*) were to be handled, emphasized the centrality of the objectives of *shariah* in general and justice in particular. He says,

> 'Allah sent His messengers and revealed His books so that people could live by justice………When signs of truth appear and proofs of reason are established and the morning-rays (of justice) shine, come they by whatever route, there lies the Law of Allah and His religion and His pleasure and His order…Whatever means help in finding out truth and recognizing justice, Law should be framed accordingly, as required (by truth and justice). Ways and means are not ends in themselves, what is desired are their goals, which are the objectives. But (Allah) has shown us the steps leading to them and their analogues in the form of whatever ways are already prescribed.' (Ibn al-Qayyim, 1977, Vol. 4, p. 373)

Following the same tradition modern Islamic scholars have taken a broader view, sometime explicitly including social goals. Thus Muhammad al-Tahir Ibn 'Aashur (1879-1973), who devoted a treatise to the subject, notes that, 'the overall purpose of legislation is maintaining order in the world and preserving its goodness by ensuring the goodness of those who are ruling over it, i.e. the human species.'…After citing texts to support his thesis he concludes, 'these clear and general arguments indicate that the objective of *shariah* is reforming (*islah*) this world and eradicating corruption (*fasad)* from it' (Ibn 'Aashur, 1366 H, pp. 63-64)…Even before Ibn 'Ashur, another great intellectual in the Maghreb, Allal al-Fasi, had stated that, 'the goal of *shariah* is the good (*maslahah*) of human being as vicegerent in the society he lives in, accountable to Allah who made him incharge for establishing justice and fairness, ensuring intellectual and social wellbeing and psychological contentment for every member of the *ummah*.' (Al-Fasi, 1963, p. 7).

Some scholars have tried to focus on the objectives of *shariah* in economic affairs. Muhammad Tahir Ibn 'Aashur lists circulation (*rawaj*),

transparency, protection, stability and justice as the things aimed at in wealth related matters. He defines *rawaj* as circulation of wealth among as many hands as possible in a fair way (Ibn 'Aashur, 1366 H, p.188).

There is no disputing the point that all Islamic provisions relating to economic affairs are directed at justice and growth. The conception of growth in Islam is, however, broader and more comprehensive than the narrowly conceived 'economic growth' in capitalism. As implied by the verses of Quran (2:151 & 3: 164) quoted above, it refers to an all rounded human personality and a society free of corruption. *Maslaha* and the protection of life, religion, reason, progeny and property, as also preservation of dignity and freedom, are rightly seen as corollaries to the broader goals of justice and growth. These are the principles scholars discover by analyzing the textual provisions, these are what Quran and *Sunnah* declare to be the objectives and these are what the legislators are supposed to keep in view while making new laws to handle new situations. It is therefore imperative that we enquire how our scholars defined justice. But before doing so we dwell a little on the relationship between justice and equity.

Justice and Equity

Something more than justice is needed to maintain the balance in human life. This something more is described in the Quran in various ways and it will be instructive to note these and appreciate the nuances.

> Lo! Allah enjoins justice and kindness and giving to kinsfolk and forbids lewdness and abomination and wickedness. He exhorts you in order that you may heed. (16:90)
>
> And if two parties of believers fall to fighting, then make peace between them. And if one party of them does wrong to the other, fight you that which does wrong till it returns to the ordinance of Allah; then, if it return, make peace between them justly, and act equitably. Lo! Allah loves the equitable. (49:9)

Distinguishing between justice and equity, Izz el-Din bin Abdussalam[#] observes that 'justice (*al-'adl*) is treating equally and with fairness, and equity

[#] died 660 H/1260 CE

(*al-ihsan*) is either bringing some benefit (*maslahah*) or preventing some dis-utility (*mafsadah*)' [Abdussalam, n.d., Vol. 2, p.161] Maududi has described *'adl* and *ihsan* in a way that helps us distinguish between justice and equity. Beginning with '*adl*, he writes:

> "This concept is composed of two elements. First, that a sort of balance and proportion should be maintained between people with respect to their rights. Secondly that everyone's due share be conscientiously rendered to him…What justice really demands is balance and proportion and not equality. In certain cases, e.g. equality in the right of citizenship, justice undeniably requires equality between all members of a society. But in certain other respects equality is quite contrary to justice, e.g. moral and social equality between parents and their children, and equality of remuneration between those doing higher services and those not so eminently engaged. So what Allah has ordained is not equality of rights but proportion and balance between them. And this requires that to every person should be rendered all his moral, social, economic, legal, political, and civic rights honestly."
>
> "*Ihsan* means good behaviour, generous dealing, sympathetic attitude, tolerance, humane and kind approach, mutual consideration and regard of one another's interest; rendering to others even more than their due rights, contenting oneself with even something less than one's own right. It is something more than justice and its importance in social life is even more than that of justice. If justice is the cornerstone of society, benevolence is its beauty and perfection. If justice saves society from undesirable things and bitterness, benevolence makes life sweet and pleasant. No society can stand as one whole if each one of its individuals is always keen on obtaining the correct measure of his own rights at all costs, conceding to others strictly what is their due and never more. Such a frigid society may well be free of strain and strife but it is bound to remain deprived of the values of love, gratitude, large heartedness, sacrifice, sincerity and altruism, which alone can give to life its sweetness and beauty, and make the good in social life grow and flourish." (Maududi, 1965, Vol. 2, p. 565)

The point of comparison is, that in ordaining benevolence along with justice, Allah is telling human beings that it takes more than justice to have a good social life.

Justice is largely perceived in terms of equivalence (in exchange transactions) and reciprocity (in social relationships). But equity (*ihsan*) is urged on top of justice and is defined as giving more than is due according to the standards of equivalence and reciprocity to ensure survival with dignity for all. It is needed to maintain good social relations and to keep away envy and other negative sentiments from the less lucky members of society. The social dimension of human life is more in view in the concept of equity than in the concept of justice. There are persons in society who are weak, invalid, poor, etc. so that they have little to give. But they must receive in order to survive. Hence exchange and reciprocity is no good for them. They need care, charity… That is what equity envisages. A rationale is provided by the fact that no one knows which one would fall in that position hence a social compact for ensuring equity is what everyone needs. That exactly is what the inclusion of equity in objectives of *shariah* has done. It is a kind of insurance making possible life with dignity for all human beings.

Care for other tempers the self-interest that is ingrained in human nature. If the latter is necessary for survival at the individual level the former is crucial for survival as a group, at the social level. Islam lays great emphasis on it. The Prophet, peace be upon him, is reported to have said:

> Mankind are God's dependents, so the most beloved of people in the sight of Allah are those who do good to His dependents. (Al-Khatib al-Umari al-Tabrizi, Mishkat al-Masabih, *Bab al Shafqah wa'l Rahmah 'ala'l khalq*)

People serve their individual and collective interests best when each individual cares for the welfare of others while striving to protect and promote his or her own interests. This is what religion teaches, those who deny it deny religion, as is clear from the following verse of the Quran:

> Thus when they are told 'Spend on others of what God has provided for you as sustenance', those who are bent on denying the Truth say unto those who believe, 'Shall we feed anyone whom if God had so willed, He could have fed (Himself)?' You are in naught else than error manifest. (36:47)

Have you observed him who denies religion? That is he who repels the orphan, and urges not the feeding of the needy. (107:1-3)

The Individual

The individual has central place in the Islamic scheme. This follows from the nature of life on earth as a test, from the belief that accountability in life after death is individual, and the fact that it is the individual, which is the ultimate actor on the stage of life. The individual person is free and he or she has certain rights.

> And each one of them will come unto Him on the Day of Resurrection, alone. (19:95)
>
> That no laden one shall bear another's load, and that man has only that for which he makes effort, (52:38-39)
>
> There is no compulsion in religion…(2: 256)

Besides the right freely to choose one's religion affirmed in the verse quoted above we note the individual's right to life, property, enterprise and to participation in political decision making as the most relevant to this study. There is a sizable literature available on these subjects, nevertheless we would cite a few texts.

In his famous sermon on the occasion of his last hajj, the Prophet declared, among other things: 'your life, your property and your dignity…are sacrosanct.' (Muslim, *kitab al-Haj, Bab Hajjat al-Nabi).*

Allah says in the Quran:

> Believe in Allah and His messenger, and spend of that whereof He has made you trustees; and such of you as believe and spend (aright), their's will be a great reward. (57:7)
> ……… and bestow upon them of the wealth of Allah which He has bestowed upon you...(24:33)

Both theses verses, while affirming that ultimate ownership belongs to Allah, recognize wealth as belonging to the individual owner, who has certain

social obligations. The verse that follows underlines the sanctity of private property and also affirms the validity of free exchange.

> O you who believe! Squander not your wealth among yourselves in vanity, except it be a trade by mutual consent, and kill not one another. Lo Allah is ever merciful unto you. (4:29)

The Prophet observed, 'Wealth rightly acquired is a good thing for the righteous man'. (Al-Bukhari, 1349H, pp. 45-46)

Trade and other economic activities are commended:

> And when the prayer is ended, then disperse in the land and seek Allah's bounty. (62:10)

Political freedoms and the right to have a say in political decision making is implied by God-given dignity as well as the nature of life as a test and the principle of personal accountability on the Day of Judgment. This does not mean a demotion of the society and social institutions nor non-recognition of their importance. After all environment has a big role in shaping an individual's personality. In the Quran there is a clear warning to all individuals that their fate depends on their social environment, which they must therefore guard against corruption and diligently work to keep in good moral health:

> And guard yourself against a chastisement, which cannot fall exclusively on those of you who are wrong doers, and know that Allah is severe in punishment. (8: 25)

> Consider the flight of time! Verily man is bound to lose himself unless he be of those who attain to faith and do good works, and enjoin upon one another the keeping to truth, and enjoin upon one another patience in adversity. (Surah [chapter] 103)

An environment of human dignity, individual freedom, property rights and a sense of accountability and social purpose, with divine guidance at hand to complement reason, is what Islam provided centuries ago. The result was one of the best civilizations humanity has ever experienced. We are not studying that experience in this book. We recall that experience as part of providing, in this chapter, a perspective on the provision in Islamic law prohibiting

riba/interest. Textual evidence on the prohibition will follow in the next chapter and the rationale of the prohibition will be provided in the chapters that follow. The point to be made at this stage of the study is: This particular provision of Islamic law, like every other provision, can be best appreciated with reference to the overall *elan,* the spirit of the environment we are, gradually, trying to understand. The juridical explications of the prohibition which we shall come across in the next chapter are in fact the situationing of that spirit in a particular context, that of economic life in general and finance in particular.

Role of the State

To complete the picture we have to turn to the role of the state, especially in economic matters. This necessitates a reference to socially obligatory duties (*furud kifayah*). Here is a typical definition: 'They are essential and must be performed, irrespective of who performs them. They include religious duties such as prayers for the deceased (*salat al janazah*) and mundane affairs like the essential industries'. (Al-Haajj, 1316H, Vol. 2, p.135) The relationship between these duties and the state is best clarified by Shatibi:

> 'Their being obligatory means that their performance is not the duty of any particular individual but they devolve on the totality of all individuals, so that those common interests are preserved without which individual interests can not be safe. They reinforce and complete the aforementioned [individually necessary objectives of *shariah*] hence they are also necessary. Individual objectives cannot be realized without realizing the social ones. Social objectives relate to the good of all men... They aim at preserving human life. Individuals are vicegerents of Allah amidst fellow servants of Allah, to the extent allowed by their abilities and powers. But a single individual has hardly the ability and the power to set his own affairs right, not to mention the affairs of his family, kinsfolk, tribe or the humanity at large. This is why Allah has entrusted the fulfillment of the common needs of mankind to the society as a whole. This is the *raison d' etre* of the state in society'. (Al-Shatibi, n.d., Vol. 2, p.177)

The state has an important place in the environment we are trying to understand. It has a role to play in realizing the objectives of *shariah* noted above. This role is complementary to the role of the individual and serves, in the end analysis, to buttress it, as noted by Shatibi. This applies to the quest for

justice and equity as well. While it is the economic and political behaviour of the individual which will ultimately determine the degree of fairness obtaining in social relations and the extent to which the weak, the poor and other disadvantaged members of society are able to survive with dignity, the state can contribute much to this cause. It can do so in many ways all of which would be impossible to list as the list varies with the circumstances. But we can note some, which are rather abiding and recurrent. We can take special note of persuasion in its various forms, education included. Providing incentives, including monetary benefits, to encourage good behavior is also relevant. Dissemination of information that could help individuals make the right decision in a particular situation suggests itself easily as a corollary. Legislation in order to oblige people to take a certain course becomes necessary, sometimes. This also may lead to penalizing the wrongdoers. But these roles have to be within a framework of freedom, in consonance with the nature of life as a test and the principle of individual accountability in the hereafter.

History

Islam in history is rich in experiences. We learn a lot from the early formative days of the Prophet and his companions. Then we go through the first few centuries of territorial expansion on the one hand and vigorous scholarship on the other hand to see how other social institutions emerged to take over roles earlier played by the state. The later centuries of low activity present different problems, till we come to the modern days of numerous Muslim nation states and large Muslim communities sharing civil life with a majority people of different faiths. The general rule has been free markets with some guidance, monitoring and regulation, called *hisbah* in early Islamic literature.

A look at the theory and practice of *hisbah* will be instructive as it is a common thread running through almost all Islamic societies till the modern times. The broad definition given relates the institution to the Quranic mandate on *al amr bi'l ma'ruf wa'l nahy 'an al munkar* (enjoining right conduct and forbidding wrong). (See Al-Mawardi, n.d., p. 208) It is interesting to note that this mandate is attached to the function of the Prophet as well as to the conduct of the believers, as in the Quran:

> Those who follow the messenger, the Prophet who can neither read nor write, whom they will find described in the Torah and the Gospel

> (which are) with them. He will enjoin on them that which is right and forbid them that which is wrong…(7: 157)
>
> And the believers, men and women, are protecting friends one of another; they enjoin the right and forbid the wrong…(9:71)

Two points are obvious. Firstly, it is a broad concept that includes market supervision but is not confined to it. In fact it extends to all walks of life. Secondly, The voluntary sector, in which individuals and institutions act without having the power to coerce, has as much to do with it as the social authority (which in the first Islamic society was the Prophet himself). It follows that Muslims looked upon the economy in general and market in particular as an integral part of life governed by the same moral and social principles. While individual freedoms were fully respected nothing was so sacrosanct as to sacrifice public interest at its altar. Also, authority and volition run parallel in Islamic living, both have a role in serving the objectives of *shariah* noted above.

Early practice shows that the institution of *hisbah* was taken seriously enough to merit the personal attention and time of the head of the state himself. The Prophet himself supervised the markets, even took personal interest in establishing them (Ibn Maja, 1975, Vol. 2, p.751, Tradition # 2233 [*kitab al-tijarat, bab al-aswaq wa dukhuluha*]). He had also assigned the job to officers appointed especially for this purpose.(Al-Kattani, n.d.,p.285) Similar measures are ascribed to the second caliph, Umar.(Malik, *Kitab al Zakat*; also Ali al Muttaqi, 1312H, Vol. 3, traditions # 2652 to 2658).This practice continued, *hisbah* becoming one of the major departments of the government during the Abbasids.

Hisbah is a good example of the quest for justice and fairness in Muslim society. While the vision remains essentially the same, rooted as it is in the Quran and *Sunnah*, the involvement of the social authority and voluntary entities varies over time and space. There seems to be a tendency to over-regulate in certain periods, often with frustrating outcomes. As the understanding of the market mechanism improves and the limits of what social

intervention can achieve are realized, a more balanced approach emerges as represented by Ibn Taymiyah in his *Al Hisbah fi'l Islam* and other works.[#]

Justice in Finance

The objective of seeing human life blessed with justice and balance has led Muslim thinkers to focus on social relations, political organization and the economy, among other aspects of life, within the framework of Islamic teachings. The first two do not concern us directly in this book. We discuss the economy too only to the extent the question of *riba*/interest is involved. That means focusing on finance.

Finance has always been important. Not everyone has inherited wealth or past savings to live by while he or she engages in the time consuming task of producing new wealth. Wealth creation takes time, meanwhile consumption must continue. Wealth creation often entails inputting goods and services from out of the wealth already available. Finance refers to money that makes it possible to acquire existing wealth for consumption and/or as inputs in the production process.

Finance is needed not only by individuals but also by institutions, private as well as public. This is more true today than it was in the earlier periods of history when the role of institutions was rather limited. One example of a public institution in need of finance is the city. A modern city government has to build a water supply system, a sewerage network, roads, public parks, schools, etc. These infrastructural facilities once built last a very long time. Their yearly maintenance cost is not very high but the initial construction costs so much money that all of it can not come from taxes, fees or charges for services rendered. Also, since these facilities give their benefits to a number of generations it is not fair to place the entire burden of their cost on the current generation. Their cost has to be met through finance and the burden should be spread over the period its benefits continue.

[#] It will be an interesting study to trace the theory and practice of *hisbah* through the ages, likely to yield valuable lessons for contemporary Islamic living as the process of understanding never stops. But we cannot afford it in this book. The reason we brought the subject up is to indicate the nature and scope of the quest for justice and equity in Islam, of which prohibition of *riba*/interest, our subject in this book, is but an aspect.

Finance helps in the production of additional wealth. When the production process is complete, we end up with more wealth than was involved in supplying the inputs including the consumption mentioned above. We are referring, of course, to the value product and not the physical product. But it is not necessarily so. Sometime the value product of a project for production is less than the value the project cost i.e. the output is less than the input in terms of value. And in neither case it is possible to know in advance the exact amount of loss or gain, i.e. the difference between cost and value of the product. The main reason behind this phenomenon is the uncertainty characterizing human environment.

Since finance generally involves X acquiring funds from Y (X and Y being individuals or institutions) it needs being decided on what terms the transaction will take place. The problem is further complicated by the fact that the information available to either parties may be different, even while it is never complete nor held with certainty. Another problem with the supply and demand for finance is that, if a financial asset carries a price, the price can be only in terms of money, which is the substance of financial asset itself. In case of goods and services this causes no problems, as money becomes the common denominator in terms of which all other exchange ratios can be reduced to prices expressed as so many units of money. But how to reduce a ratio of exchange between money and money to a price expressed in the units of the same money?

In the theory and practice of finance we are faced with a situation in which a transaction of crucial importance for life has to be effected in a way different from all other transactions.

The Islamic quest for justice and equity led it to the recognition of the crucial importance of finance in life. Having expounded a positive attitude towards economic activity and bestowed enterprise and trade with Allah's blessing, Islam was quick to realize how important finance (funds supplied by others to be used in producing wealth) was in that context. No project for establishing a just and equitable society could succeed if it ignored this fact. Islam paid it the fullest attention.

Islamic Rules for Exchange

In an economy with real goods and services, money and financial assets in the form of promises to pay (i.e., debts), exchange can be divided into the following six categories:

Goods for money
Goods for debt
Goods for goods
Debt for money
Debt for debt
Money for money

Categorizations are rarely all-inclusive or completely free from overlapping. This is especially true of our age in which innovative 'assets' abound. But we feel the above will do as a first abstraction and newer kinds of assets can easily be accommodated in one category or other.

Without going into details, it can be seen that Islam left the first two to the free interaction of the parties concerned. Supply and demand will determine the prices in the real markets, be the prices paid in cash or prices to be paid in future as in case of credit sales. There are rules for this market, as we indicated in our reference to *hisbah* above, but the market itself is essentially free.

As regards the third case, exchange of goods for goods, i.e. barter, Islam seems to have adopted a three-pronged approach: encourage mediation by money, subject exchange of similar commodities to the rule of simultaneity and equality in exchange (i.e. rules of *riba'l-fadl*, as we see later) and leave it to the convenience of the people in the rest of the cases.

These three markets (goods for money, goods for debt and goods for goods) taken together, in which commodities are exchanged for one another or sold against cash or credit, constitute the real sector of an economy. As we have discussed elsewhere (Siddiqi, 1996, pp.104-05) Islamic Law seeks to rid these markets of corrupt practices. *Riba*, *qimar* (gambling), *ghaban* (fraud), *ikrah* (coercion), *bay*' *al-mudtarr,* (exploitation of need) *ihtikar* (hoarding), *najsh* (raising prices by making false bids), *gharar* (hazard) and *jahl mufdi ila al-niza*' (lack of information leading to dispute) are sought to be kept out in order to ensure fairness and promote welfare. Obviously the same applies to the remaining three markets which, taken together, are characterized as financial markets. In these markets money and promises to pay money, debts, are the objects of exchange, sale and purchase. Financial markets also include stocks or

shares of business enterprises, even though one could point out their hybrid nature. The important point to note is that these markets have certain peculiarities, which make them more vulnerable to corrupt practices than the real markets. We, therefore, find that Islamic Law has more stringent rules governing financial markets than those governing real markets.

Regarding exchange of money for money it has to be in equal quantities, if it is the same currency. If the currencies are different the quantities can be different but the exchange must be simultaneous. An exchange of debt for debt must also be in equal quantity. The same applies to an exchange of debt for money.[#]

The reason the financial markets, in which money and debts are traded, have more constraints attached to them than the real markets, seems to be that information deficit is larger and more widespread in this market. It is much more difficult to ascertain the quality of debts than it is with respect to commodities. Money suffers from the same weakness, especially money that does not have any intrinsic value, i.e. non-commodity money. Ensuring fairness in financial markets requires minimizing the chances of harm to either party in conducting a transaction, which invariably involves information deficit and/or uncertainty.

In principle, there are two things that could be done in this regard: increasing information, reducing uncertainty and blocking transactions that are likely to do more harm than good because of irreducible uncertainty and unavailable information.

The juristic term for the situation characterizing most financial markets, uncertainty and information deficit, is *gharar*. It so happens that *gharar* is much more widespread in the financial markets than in the commodity markets. And very often the *gharar* involved is quite large. Islamic law has dealt with *gharar* in a pragmatic way, allowing deals with amounts of *gharar* small enough to make it probable that advantages of allowing the deal are greater than the resulting harm, and disallowing deals involving large amounts of *gharar.* That we find whole categories of transactions in the financial markets blocked is because the gain (in efficiency?) from allowing these transaction is little

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[#] Some controversy on this point will be reported in later chapters, but it does not affect the thrust of our argument at this juncture.

whereas the loss (in fairness?) from allowing them is great. Also, some of the blocked transactions in the financial market seem to be directed at preventing *riba,* i.e., the transaction could be a means to extracting an excess over and above the sum lent. The condition of simultaneity in exchange of one currency for another and of equality in exchange of debt for debt, fall in this category.

An elaboration of the above would take us into a detailed discussion of *riba* as well as *gharar*. Our study in this book is, however, confined to *riba,* whose nature and scope is the subject of the next chapter.

Conclusions

It is time briefly to recapitulate what we have discussed in this chapter. Islam makes man's relation with God guide man's relations with others and with all that is there in environment. That is what would guarantee human felicity in life on earth as well as success in life hereafter. This guidance comprises morality as well as laws. The individuals with their moral orientations and voluntary actions as well as the state with its power to supervise and coerce, both have a role. Part of the Islamic guidance relates to economic life including finance. What is sought in the financial system is justice and equity. Islamic history is rich in examples of how to realize justice and equity in economic life in general and finance in particular. Prohibition of *riba*/interest is part of Islamic guidance designed to play a key role in ensuring a just and equitable financial system.

CHAPTER 2

PROHIBITION OF *RIBA*

In this chapter we study the law of Islam regarding *Riba*. We start with the verses of the Quran in which *riba* is mentioned. We also try to find out the reasons behind its prohibition insofar as they are indicated in the Quran itself. We proceed to see how in implementing the law the Prophet, peace be upon him, prohibited some transactions other than loans and sales on credit (stipulating *riba*) which could serve as a cover for realizing *riba*. We also look at the way the Companions of the Prophet and the generation of Muslims that followed them understood the law of *riba*. We follow up by noting some of the other discussions on *riba* related matters that ensued through the ages. Coming to our own times, we have a look at bank interest and ascertain whether it conforms to what is prohibited. This is followed by a discussion on some dissenting voices in recent times which do not see modern bank interest as the *riba* prohibited in Islam.

Quran on *Riba*

There are 12 verses in the Quran dealing with *riba*. The word *riba* itself occurs eight times, three times in 2:275 and one time each in 2:276; 2:278; 3:130; 4:161 and 30:39. We reproduce these verses below, in translation, with some comments as to their implications and the possibility of inferring the reasons behind prohibition from them[3]. First of all we have the six verses in the second chapter, *al-Baqarah:*

> Those who swallow usury cannot rise up save as he arises whom the devil has prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permits trading and forbids usury. He unto whom an admonition from his Lord comes and (he) refrains (in obedience thereto), he will keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returns (to usury)-- Such are rightful owners of the Fire. They will abide therein.

[3] All translations are from the Meaning of the Glorious Quran by M. M. Pickthall. These verses are given in the order in which they occur in the Quran.

> Allah has blighted usury and made almsgiving fruitful. Allah loves not the impious and guilty. Lo! Those who believe and do good works and establish worship and pay the poor-due their reward is with their Lord and there shall no fear come upon them neither shall they grieve. O you who believe! Observe your duty to Allah and give up what remains due to you) from usury, if you are (in truth) believers. And if you do not then be warned of war (against you) from Allah and His messenger. And if you repent, then you have your principal (without interest). Wrong not and you shall not be wronged. And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that you remit the debt as alms giving would be better for you if you did not know. (2: 275-280)

These verses establish a number of important points. Firstly *riba* is categorically prohibited, secondly, it is stated that *riba* is what is over and above the principal and thirdly that it is unjust (*zulm*). It is also said that *riba* is destined to destruction (*mahq)*. And last but not the least, the worst effect of *riba* mentioned in the above passage is that on human personality: *riba* demeans and diminishes individuals who indulge in taking it. Significantly, the claim of equating *riba* with trade is also rejected (trade being mutually beneficial whereas the benefits of *riba* may well be confined to one party only). We will have to say more on these points after we go through the other verses.

Next comes a verse in the third chapter, *Aal e Imran*. This verse underlines the tendency of *riba* to balloon manifold, multiplying its ill effects.

> O you who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that you may be successful.(3:130)

This is followed by a verse in the fourth chapter, *al Nisa*

> Because of the wrongdoings of the Jews We forbade them good things which were (before) made lawful unto them, and because of their much hindering from Allah's way. And of their taking usury when they were forbidden it, and of their devouring people's wealth by false pretences. We have prepared for those of them who disbelieve a painful doom. (4; 160-161)

This verse informs us that *riba*, which has been prohibited for us, was also prohibited for the Jews, thus providing us a new means of understanding the meaning of *riba*.

Last in sequence, we have the verse in chapter thirty*, al-Rum*:

> That which you give in usury in order that it may increase on (other) people's property has no increase with Allah; but that which you give in charity, seeking Allah's countenance, has increase manifold. (30:39)

This verse declares that the increase in wealth sought through taking *riba* from people to whom it is given is not blessed by Allah.

Having gone through the texts, we have now to clarify a number of issues which are involved before we can answer the question most important in modern times: Is bank interest covered by the *riba* prohibited in Quran?

These issues relate to the meaning of *riba* and as to what was covered by it at the time Quran was revealed. Insofar as it related to loans and sales on credit, was the practice of lending and selling on credit confined to the poor? If it was not, and loans as well as credit sales were also made to traders doing business with what they borrowed or purchased on credit, or to those engaged in agriculture, horticulture, animal husbandry, etc., what was the reason of prohibiting it? What is implied by rejecting the argument that trading is like taking *riba*? What is the connotation of *zulm* which is sought to be prevented? We take these issues one by one.

Meaning and Incidence of *Riba*

It is unanimously agreed that *riba* means an increase or growth. Some insist it is the increase imposed on the debtor at the maturity of the debt in case he/she fails to pay it and wants to roll it over. They say so because they think the predominant form of transactions involving *riba* was sale on credit in which case the (deferred) price was already higher than the spot price in lieu of deferment and the need for an explicit increase arose only in case of further postponement of payment. The majority of scholars, however, thinks that it covers the interest stipulated at the time of the contract in case of loans as well as the subsequent increases in case the loan or the debt arising from sale on

credit is rolled over because the debtor does not pay it at the time stipulated in the contract. (Badawi, 1964, pp 26-41)

This brings into focus what was actually going on during the seventh century, especially in Arabia. Both history and common sense make us think that, whatever their relative strength, both lending of cash and kind and credit transactions were prevalent in Arabia as well as the rest of the world (Al-Misri, 1991, pp.23-26). Also, starting from the proposition that what is prohibited in Quran was also prohibited in Torah (Old Testament), a reference to the Old Testament makes it clear that loans as well as credit transactions were prevalent at the time Moses got the Law (Deuteronomy, 23:19,20; Exodus 22:25; Leviticus 25: 36-37; Psalms 15-35; Proverbs 28:8; Ezekiel 18-13; 22 :11-12 and Nehemiah 5: 1-13. vide Mills and Presley, 1999, p.103 and p.139; also see Wilson, 1997, pp. 33-34).

Another related issue is whether it was only to the poor and the needy that interest bearing loans and credit sales were made, as some people seem to be arguing[4]. This claim cannot be sustained in the face of the historical evidence, as we shall see below. It also runs counter to common sense. If lending in cash and kind to business people as well as credit sales to them was in fact prevalent, why should it be free of interest in an environment in which, as claimed, interest was being charged from the poor? The only assumption that appeals to common sense is that either interest did not exist in that society or it existed throughout the economy, in the consumption sector as well as in the production sector.

The *Riba* Owed to Abbas

Historically one of the most important cases of large scale dealing in *riba* is that of Abbas bin Abdul Muttalib, the Prophet's uncle. It is mentioned in the last sermon of the Prophet in which he declared:

> "*Riba* of the days of ignorance stands nullified. And the first *riba* I cancel is our own *riba*, the *riba* owed to Abbas bin Abdul Muttalib. It

4" The economy of Mecca and Medina at the time of the prophet was more or less a subsistence economy, and large scale lending and borrowing for non-humanitarian purposes did not seem to be widely practiced. Debt in that society appears to have been generally a means of meeting a pressing need on part of the economically disadvantaged". (Saeed, 1996, pp.39-40)

> stands nullified, all of it.” (Muslim, *Al-Jami‘ al-Sahih, Kitab al Haj*, *Bab Hajjatunnabi, sallallahu alaihi wa sallam.* [Beirut, Dar al Fikr, n.d., Vol. 4, p.41])
>
> “All *riba* is annulled. But you will get back your principal amounts. Neither shall you wrong nor shall you be wronged against. Allah has decried that there shall be no *riba*. The *riba* of Abbas bin Abdul Muttalib is cancelled, all of it”. (Ibn Hisham, n.d., Vol. 2, p. 603)

What kind of debts these were? To whom were they given? Their amounts must have been very large and those involved as debtors must have been many, for these debts to merit singling out for mention in a speech of such importance.

Abbas did not migrate to Madinah even after he embraced Islam around year 2 A.H. but stayed on in Makkah with the Prophet’s permission, and according to some reports, at the Prophet’s suggestion (Al-Khuza‘i, 1985, p.164). His social stature in Quraish, the leading clan of the town, his immense wealth (Ibn Hisham, n. d. Vol.1 p. 646) and his political clout that made him a protector of all those who failed to migrate (Al-Khuza‘i, 1985, p.164) are well-established facts. It does not make sense that all his debts were owed by the poor, having been taken for consumption purposes. Why would this wealthy man not lend to the rich merchants of Makkah for business? Is it imaginable that he did lend to the rich businessmen but did not charge interest from them, charging interest only from the poor as some seem to think? (Saeed, 1996, p. 28) And how could he retain the reputation of a good Arab, exploiting the needs of the poor, as Arabs regarded generosity towards the needy as their distinctive virtue. How could he be looked upon as a good Muslim related to the Prophet and leader of the Muslims who stayed on in Makkah? Certainly making one’s fortune by exploiting the needs of the poorest was not going to help one in these regards. The fact of the matter is, he dealt mostly in the production sector. He extended credit to farmers as well as traders. He along with Khalid bin al-Waleed was among the main financiers of the North and South bound trade caravans mentioned in the Quran (chapter 106) for which Makkah was well-known. They together used to finance a group of businessmen belonging to Thaqeef tribe in the nearby town of Taif (Al-Misri, 1991, p.51). Abbas along with Usman bin Affan, who later became the third among the four pious caliphs, are reported to be financiers of date crops (most probably both in Yathrib [later Madinah] and Taif) (Al-Razi, 1978, vol. 2, p.359).

Older than the Prophet by a couple of years, Abbas, one of the ten male children of the Prophet's grandfather, Abdul Muttalib, succeeded his father into the important position of guardianship of Zamzam which involved supplying water to the pilgrims during Haj (Ibn Hisham, n.d. Vol. 1, p.178). That was before Islam. He was confirmed in this position even after Makkah came under the Prophet's rule. He supported the Prophet even before he himself embraced Islam. This is evidenced by his key role in getting an agreement with a group of pilgrims from Madinah, which town he frequently visited as a trader, for the Prophet's hijrah during a secret meeting known as Aqba II (Ibn Hisham, n.d. Vol. I, pp 439-41; also Al-Dhahabi, n.d. Vol. 2, p. 86). His role was crucial in getting a generous deal for the people, including the pardon for Abu Sufyan (subsequent to his embracing Islam as suggested by Abbas) from the Prophet at the time Makkah was conquered (Ibn Hisham, n.d. Vol. 1, 402-03). He stood by the Prophet on the occasion of the temporary setback at Hawazin, protecting him and using his extraordinarily high pitch voice to call people back to battle (Ibn Hisham, n.d. Vol. I, p. 445). His enormous wealth was also at the service of Islam as evidenced by the fact that once he paid *zakat* for the current year as well as for the next year as desired by the Prophet (Al-Darqutni, n.d. Vol.2, p.124 [*bab ta 'jil al sadaqah*]). The idea that he made a fortune by extracting *riba* from the poor peasants who sold their date crops in advance but failed to deliver the crop as that would not leave them anything to subsist on (Suhail, 1999, p. 146), militates against the picture we get from the sources. The Prophet himself is reported to have described him as among 'the most generous givers' among the Quraish (Al-Dhahabi, n.d., Vol. 2 p. 91). He used to provide clothes and food to the needy among bani Hashim and spend freely to help neighbors and to meet social contingencies (Al-Dhahabi, n.d., Vol. 2, p. 80). He was a man of property who used his wealth for social services too. He had orchards in Taif producing raisins which were brought to Makkah to be used in preparing drinks for the Haj pilgrims. (Al-Baladhuri, 1959, p.68)

Abbas was well-established as a merchant even before Islam (Saleh, 1984, Vol. 4, p. 321). His business deals were multifarious including *mudarabah* (Al-Baihaqi, n.d, Vol. 6, p.111). His financing modes also included *salaf* (*salam*) or advance payment for the next crop, which was a lucrative business as on delivery the crop could, normally, be sold for cash at a price higher than the purchase price. It is in these cases that sometime the seller requested postponement of delivery, or part of the delivery, in exchange of added *riba*. It is naïve to suggest that such postponement could only have been

prompted by poverty. It could very well have been due to market conditions favoring a roll-over.

To suggest that the huge debts owed to Abbas by Thaqeef in Taif could only have been consumption loans to the poor goes also against the nature of his relationship with that township. As reported earlier it was a business relationship. The people in Taif were prosperous people due to their rich orchards and other cash crops.

We have dwelt at some length on the case of Abbas bin Abdul Muttalib because what is true about him would also be true about other traders of repute and men of money like Usman bin Affan, Rabi ‘ah and Khalid bin Waleed. The *riba* outstanding at the time it was nullified by the Prophet's edict on the occasion of his sermon in his parting Haj included interest on commercial loans as well as consumption loans. It comprised both of interest stipulated in the original contract (as is the practice in loan in cash or kind) and interest added in lieu of postponement of payment in case of credit sale or postponement of delivery in case of advance payment for crops as in *salam*. And, lastly, it comprised both of *riba* owed by rich traders as well as by poor consumers. There is no basis for confining the *riba* mentioned in the Quranic verses noted above to the consumption sector, or to credit sales or *salam* or to the debts owed by the poor only. It was, as it had always been and continues to be till date, all pervasive, spread throughout the economy.

Reason of Prohibition

We would now take up the issue, what is the reason behind prohibition of *riba*, insofar as that reason is indicated in Quran. Even though we do not get the reason in the form of a direct statement, a number of reasons can be inferred from the texts read in their context. We single out five such reasons;

Riba corrupts society.
Riba implies improper appropriation of other people's property.
Riba's ultimate effect is negative growth.
Riba demeans and diminishes human personality.
Riba is unjust.

The first reason reveals itself when we read the above mentioned verse from chapter 30, sura *Rum*, along with some of the preceding and following verses. These read:

> See they not that Allah enlarges the provision for whom He will, and straitens (it for whom he will). Lo! Herein indeed are portents for folk who believe. So give the kinsman his due and to the needy, and to the wayfarer. That is best for those who seek Allah's countenance. And such are they who are successful. That which you give in usury in order that it may increase in other people's property has no increase with Allah; but that which you give in charity, seeking Allah's countenance, has increase manifold. Allah is He Who created you and then sustained you, then causes you to die, then gives life to you again. Is there any of your (so called) partners (of Allah) that does aught of that? Praised and exalted be He above what they associate with him. Corruption does appear on land and sea because of (the evil) which men's hands have done, that He may make them taste a part of that which they have done, in order that they may return. (30: 37-41)

The association of charging interest with *fasad,* translated as corruption by M. M. Pickthal, is significant. Within the framework of the general message that *fasad* in society results from men's own (wrong) behavior, we can clearly read the sub-message that charging interest is one of those wrong behaviors that corrupt the society. As the experts say, this may have been the first time, chronologically speaking, that *riba* was mentioned in Quran. It was in the fitness of things to highlight its negative social role long before the practice of charging interest was banned.

What is meant by *fasad* in the above verse, and in what way charging interest on loans could be related to it? Read some of the numerous verses in which the word has occurred in the Quran and you get an idea of its dimensions. What is interesting in our context is the inclusion, into the concept of *fasad*, of 'destruction of crops and people' (2: 205), 'severing the ties of kinship' (47: 22), dividing people into classes and discriminating between them (28: 4), 'shedding bloods' (2:30), giving people less than full measure and wronging them in their goods (11: 85; 26: 183), arrogance borne of enormous wealth (28: 77) and sexual perversion (29: 28-30).

The second reason, *riba* amounting to unlawful appropriation of other people's property is indicated in the verse from chapter four, *sura al-Nisa'* quoted above. In that verse the Jews are admonished for 'taking usury when they were forbidden it, and of their devouring people's wealth by false pretences' (4: 161). There lies a hint as to a generic connection between *riba* and *akl bi'l batil.* Significantly, Quran relates the tendency to appropriate other people's wealth without any justification to some more serious crimes. In (9: 34) it is associated with hoarding and (4 : 29) seems to put it at par with murder.

Considering the serious dimensions of *fasad* and *akl bil-batil* to which *riba* has been related, the message seems to be: charging interest belongs to a mind-set that leads to disruption of civil society.

As rightly pointed out, 'interest on money is regarded as representing an unjustified creation of instantaneous property rights: unjustified, because interest is a property right claimed outside the legitimate framework of recognized property rights; instantaneous, because as soon as the contract for lending upon interest is concluded, a right to the borrower's property is created for the lender'. (Khan and Mirakhor, 1987, p. 4)

The third reason is implied in the declaration that *riba* is subject to destruction [*mahq*] (2: 276) which means decrease after decrease, a continuous process of diminishing. That sounds a little odd as it runs counter to the commonly observed fact of people growing rich by doing the business of lending on interest. Once we leave out the improbable interpretation of individual wealth amassed through *riba* business being subject to continuous decrease, we have to turn to the social wealth. *Riba*, even when it is increasing in numerical terms, fails to spur growth in social wealth. That role is played by charitable giving mentioned in the next half of verse 2: 276. Charitable giving transfers purchasing power to the poor and the needy who spend it. The destination of interest is not that certain.

One needs being reminded that the concept of *mahq* or the implied decrease in social wealth may not necessarily refer to national income in dollars. It could very well be referring to some real measure of human felicity. And that takes us to the next reason.

The fourth reason behind prohibition of *riba* is inferred from verse 2:275 quoted above. This verse draws a picture of 'those who devour usury' as well as

states the reason why they got into that pitiable mould. That reason is their being trapped into a false economics that equates trade—the act of selling and buying - with the practice of charging interest. (However, it would not be far-fetched to surmise that this 'trap' was invented for the simple folk as we note below). We intend to discuss the rejection of this economics below at some length. At this stage we would like to draw attention towards the interesting phenomenon of how having your economics wrong can doom you!

We would also like to note that some scholars think the picture painted of the one who takes *riba* belongs to the Day of Judgment, in the hereafter, not in this world. But that still leaves the main question unanswered: what is so wrong about taking interest to deserve that fate? The answer to that question has to be in line with the cause given in the later part of the verse itself: 'That is because they say: Trade is just like usury'. It is obvious that the cause lies in the behavior arising from the mindset revealed by that saying, not in the mere act of saying. If that is so, the behavior should show its effect in this world too. It is, therefore, better not to confine the picture to the hereafter. Let it cover both the personality of the *riba*-eater in this life on earth as well as his/her condition on rising from the grave in afterlife to face the Day of Judgment. (Al-Misri, 1991, pp. 42-43)

Regarding the impact of taking interest on personality, the question arises: How can this apply to millions of small savers who receive interest on saving accounts? As we shall see later, a plausible answer lies in the generally rising level of anxiety in modern interest based societies. The fact of the matter is that in the complex modern economy the relationship between the one who pays interest and the one who receives interest is not direct and visible as in the primitive agricultural societies or merchant communities of the old. It is mediated by numerous agencies and institutions, which fact makes it entirely impersonal. Also, it is invisible. It appears as credit or debit entries in one's bank account. The same person may be receiving interest as well as paying interest in the same period of time. There is no way of understanding the impact of this practice of charging interest on loans taken or of interest paid on loans obtained other than analyzing the system as a whole. It is only with reference to modern interest based system of banking, finance and monetary management as a whole that the effects of *riba* on human personality mentioned in verse 2: 275 or that on society mentioned in verse 30: 39 can be understood.

The last, but not the least important, reason of prohibiting *riba* is its being unjust, as the verse 2: 279 implies. It clearly states that taking an amount in excess of the principal would be unfair, unjust. It also recognizes the right of the lender/creditor to the principal without any decrease as that too would be unfair, unjust. The Quran does not argue further as to why it is unfair to take an excess in case of loan. Presumably it relies on the notions of equality and reciprocity inherent in the concept of justice as indicated in the first chapter above. The unacceptability of injustice and unfairness was never in dispute between the Quran and its audience. It continues to be so in the modern times. What is not acceptable to many is the Quran's stand that taking any thing in excess of the principal amounts to injustice. To resolve this dispute we have to turn back to the difference between trade and interest-based transactions. That was the bone of contention between Makkan traders opposing the Islamic injunction and the Prophet, as reported in verse 2: 275.

Profits Versus Interest

Trade facilitates exchange. Exchange creates value. Traders try to capture part of the value so created. The margin between the price they paid and the price they charge, the difference between the sale price and the purchase price, is called profit. The same is described as the difference between total revenue and total cost, in order to cover things made/prepared by the seller, as in handicraft and manufacture. A peasant selling agricultural products grown on his own land can also be covered by the same, and so on.

Sometimes the difference between the sale price and the purchase price, i.e., that between revenue and cost, is negative. In that case it is called loss. Trade is subject to profits as well as losses. No language has different words for loss making trade and profit making trade. It is in the nature of this activity to be subject to occasional losses.

Trade has been a morally acceptable activity in the human societies since the earliest times. All religions approved of it. The Quran mentions it approvingly and so does the Prophet who himself was a trader before assuming his prophetic responsibilities. It may also be noted that trade covers sales on credit as well as sale for cash price. It also covers sale of a commodity to be delivered in future against price to be paid in cash, on the spot.

It is on this universal and undisputed acceptability of trade and profits on which some tried to hang their claim as to the legitimacy of *riba*, a claim rejected outright by the Quran. That *riba* is an excess was not under dispute. What was rejected was the assertion that trade profits too were an excess like *riba* was. That claim glosses over a number of facts inconvenient to the claimants.

The claim ignores the possibility and occurrence of losses that exist in trade. In other words it ignores the uncertainty faced by the trader. That implies that even the recovery of the capital invested in trade is not assured. A *riba* contract, on the other hand, ensures the recovery of capital and seeks a positive return. It also ignores the fact that profits are not predetermined as regards their size, unlike interest whose size is part of the contract. Even when a contract provides for a variable rate of interest, it is different from profit in trade that is not at all amenable to contracting. The most important fact ignored in the claim is that in trade both parties to the transaction proceed on the basis of some definite advantage perceived by each one of them, which advantages are available then and there at the time of the contract. But this cannot apply to an exchange of present money for money to be paid in future, as happens in a loan transaction. The reason lies in the nature of money as distinct from other goods and services, as we shall see below. In other words, there is always a counter value to profit in trade whereas there is no counter value to interest.

To the possible rejoinder that *riba* too is subject to a risk of loss insofar as default can take place, it can be pointed out that the risk of non-fulfillment of contract or default is different from the uncertainty of (future) revenues faced by a trader. This uncertainty, based on the uncertainty of future prices is a feature of free markets against which no insurance is possible unlike the risk of default, which is amenable to insurance.

It is also not credible to make an analogy between selling on credit (usually at a price higher than the cash price, thus involving an ‘excess’) and taking *riba* in the form of adding more to the (deferred) price contracted for. That amounts, in effect, to saying: What justified the increase over cash price in the first instance also justifies adding a charge in case of further postponement of payment of the amount due. This second step is exchange of money at a particular time for more money in the future. It is no longer sale of a commodity for money in the future. All that has been said above in relation to lending on interest applies to it also.

Profit in trade, whether in sale for cash or credit, accrues only once. Once accrued, it does not increase. Its size is equal to the difference between cost, already incurred, and the price agreed upon. But *riba*/interest is made to go on increasing with the passage of time.

Coming back to the claim: Trade is just like usury, many explanations have been offered for the rather blunt treatment of the claim by Quran. No counter argument is presented. Rather there is a terse declaration: ‘Allah permits trading and forbids usury’ (2: 275). I am inclined to think that this is done in disdain, to convey the message that the above ‘argument’ is no argument at all. It amounts to pure hoodwinking. It is an old trick to which the leaders in Makkah resorted to mislead their simple folks. Read for example the following:

> And when it is said unto them: Spend of that wherewith Allah has provided you, those who disbelieve say unto those who believe: Shall we feed those whom Allah, if He willed, would feed? You are in naught else but error manifest. (36: 47)

We find that instead of responding to a flimsy ‘argument’ that was no argument at all but a trick to hoodwink simple folk, the Quran heaps scorn on those using that ‘argument’. The same appears to be the case in the context of their claim: Trade is just like usury.

In rejecting the piece of economics that equates trade with *riba* the Quran is also rejecting the equation between money and other goods. What is acceptable in the case of the latter is not necessarily acceptable in the case of the former in view of the fact that money is, primarily, a means. In the process of exchange it is a great facilitator. In an exchange between money and goods only the willing consent of the parties to the exchange is important (assuming the other conditions relating to information, absence of fraud and the like). The quantitative dimensions of the deal and the timings involved are left to the parties concerned. Not so when goods are exchanged for goods or money is exchanged for money. As we shall see while studying how the Prophet applied the prohibition of *riba* during his times, goods for goods on the spot as well as goods for goods with some time in between give and take, both need special handling in order to ensure fairness and protect all relevant interests because of the immense varieties involved. When it comes to money for money the case is simpler.

Quran's Emphasis on Charitable Giving

The condemnation and prohibition of *riba* in Quran is almost always accompanied by urging the believers to give. That includes both charitable grants (*sadaqa*) and *qard hasan*, lending with no obligation for the borrower more than returning the principal This fits in with Islam's over-all vision of life as a cooperative venture aiming at passing the test for which the Creator launched the enterprise of life and death (67:2). There is no justification, however, of making it a 'proof' of *riba* being confined to the consumption sector and its prohibition being directed *only* at protecting the poor borrowers from being exploited by the rich lenders. The former point of fact belongs to history. Whether *riba* in Arabia of seventh century C.E. existed in the commercial/production sector or not must be decided on the basis of historical evidence. The later point relates to law and must be discussed in the light of the relevant texts. Substantive issues of crucial importance in Law should not be allowed to be decided on inferential grounds.

Prophet's Implementation of the Prohibition of *Riba*

In implementing the prohibition of *riba* the first focus of the Prophet was any excess charged in financial transactions for which no counter value existed. Arabs in those days did not have their own money. They used the Roman dinars, a gold coin, and the Persian dirhams, a silver coin, as well as un-minted gold and silver. The economy was sparsely monetised and most exchanges, especially those outside the urban centers, were in the nature of barter, i.e. goods for goods. The following hadith is to be read in that perspective:

> Reported by Abu Sa 'id al- Khudri, the Prophet, peace be on him, said: "Do not sell gold for gold except when it is like for like, and do not increase one over the other; do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away [from among these] for what is ready". (Al-Bukhari, *Sahih, Kitab al Buyu*', *bab bay' al fiddat i bil fiddah*).
>
> According to another report the Prophet said:
>
> "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt---like for like, equal for equal and hand to hand. If the commodities differ, then you may sell as you wish,

provided that the exchange is hand to hand". (Muslim, *Al-Jami 'al-Sahih*, *Kitab al-Musaqat, bab al-sarf wa bay'al-dhahab bi'l-waraq naqdan)*

There are numerous reports to the same effect which can easily be traced through other works (Al-Misri, 1991, pp. 65-75; Badawi, 1964, pp. 85-98). The constraining of exchanging gold for gold or silver for silver by the two conditions of simultaneity and equality is clearly directed at preventing exchange of money now for more money in future, i.e. for preventing interest on loans. But the *hadith* does more than that:

Firstly, it bans exchange of money now for more money now.

Secondly, it also bans in case of four specific commodities what it banned for money in the form of gold and silver.

No reasons are given except that in some reports it is mentioned that a violation of the ban would amount to indulgence in *riba* (For another report by Abu Sa'id al- Khudri in Sahih Muslim as well as in Musnad Imam Ahmad, See Chapra, 1985, p.239).

The first, prohibiting money now to be exchanged for money now except in equal quantities, would appear puzzling to many. Why would any rational person do that? And if there is no incentive for doing that, what was the need for the ban? But the puzzle is solved the moment one pays attention to the non-standardized nature of money, even in the form of gold and silver, in use in that area in those days. There were differences in quality because of adulteration. There were also differences in weights of coins circulating under the same names. This made transactions very complex, especially for simple illiterate folk from rural areas who rarely handled gold and silver. Also, one could easily, but falsely, be persuaded to exchange gold with gold (bullion or coins) or silver with silver (bullion or coins) in unequal quantities on the pretext of differences in quality. By confining exchange to equal quantities these possibilities of injustice were eliminated.

The four specific commodities mentioned in the above *hadith*, wheat, barley, dates and salt have been clubbed together with gold and silver as they were used as money. The well-known difficulties of barter forced people to use other conveniently available commodities as medium of exchange. Despite their

suitability on other grounds, the availability of gold and silver in Arabia was rather limited. People used as medium of exchange what was available in almost every village: the most commonly grown food items and salt obtained by evaporating sea water or from some mines. The fact that food items could not conveniently perform some functions of money like that of store of value and means of deferred payments was not decisive in subsistence economies. The two primary functions of a medium of exchange and a measure of value were served well by wheat, barley, dates and salt that were easily available in all villages.[5] In prohibiting *riba'l fadl* (the excess involved in barter of similar commodities), therefore, the Prophet was also bringing some order into an otherwise chaotic financial market.

> Reported by Abu Sa'id al Khudri and Abu Hurairah: A man employed by the Prophet, peace be upon him, in Khayber brought for him *Janibs*. The Prophet asked: Are all dates from Khayber like this? The man replied, By God, no, O! Prophet. We take one Sa' of these for two, or two of these for three. The Prophet, peace be upon him, said: Do not do that. Sell the *Jam'* for dirhams then buy *Janib* with dirhams. (Al-Bukhari, *Sahih, Kitab al Buyu*', *bab* no. 89, *idha arad bay' tamarin bi tamarin khairin minhu*)

Some other reports of the same or similar events mention the Prophet's characterization of the deal as *riba*. (Muslim, *Al-Jami ' al-Sahih, Kitab al Musaqat, bab al ta'am mithlan bi mithlin, hadith* numbers 4-6)

This step taken by the Prophet seems to be directed at making the process of exchange fair as well as efficient. Replacing exchange of goods for goods by exchange through money subjects the evaluation of each commodity to a social process. The money price of a commodity is determined by the interaction between demand and supply that reflect the preferences of all buyers and sellers. This is not the case when one individual is dealing with another individual in which only their individual circumstances, likely to affect the ratio in which their respective goods are exchanged for one another, are reflected. It

[5] Imam Shafa'i has noted that wheat was a currency in Hijaz like dinars and dirhams (Al- Shafa'i, 1996, Vol. 6, paragraph 8683). The use of salt 'for exchange as people use gold and silver' has been reported about Mali (Ibn Bashkwal, 1966, Vol.2 p. 773; 779). For more historical evidence and detailed reasoning, see Awad, 1978, pp.7-18; Al-'Anani, n.d., pp.41-44. Also see Tobin, 1992-94, p.771.

reduces the search costs for both parties and lessens sharply the possibilities of exploiting the other party's special circumstances (such as ignorance, urgency of need, etc.). We have insightful comments by eminent scholars underlining this point.

The famous thirteenth century philosopher-jurist, Ibn Rushd, has the following:

> "It is clear from the *shariah* that the purpose of prohibiting *riba* relates to the possibility of great cheating that exists therein. Justice in transactions lies in approximating equivalence. So, when realizing equivalence between different things was found to be almost impossible, dinar and dirham were made to evaluate them, that is, measure them. As between different kind of commodities, I mean those that can neither be weighed nor measured, justice lies in their being proportionate. The ratio of the value of one thing to its kind should be equal to the ratio of the other things to that thing's kind. To give an example: when a man is selling a horse for clothes, justice requires that the ratio of the value of that horse to horses should be same as the ratio of the value of that piece of clothing to clothes. If the value of that horse is fifty, the value of those clothes must also be fifty. Let it be ten pieces of clothing, for example, that would ensure equivalence. So, these commodities have to be unequal in number from one another in just transactions, as one horse is equivalent to ten pieces of clothing in the example." (Ibn Rushd, 1988, Vol. 2, p.135)

The efficiency dimension of the prohibition of *riba* is further explained by Mahmoud El-Gamal with reference to the paragraph in Ibn Rushd immediately following the one quoted above. (El-Gamal, 2001, pp. 6-8)

Understanding of Law of *Riba* by Companions of the Prophet and those who Followed

A unique dimension of the prohibition is reflected in the way Aisha, the wife of the Prophet, reacted to a deal in which a lady purchased something for six hundred dirhams paid in cash whereas she, the purchaser, herself had sold it to the same person for eight hundred dirhams on credit. Aisha condemned the deal and said it involved *riba*. (Al-Andlusi, 1993, Vol. 2, p. 349; Ibn Rushd, 1988, Vol. 2, p. 145). It will be noted that each one of these two transactions

was beyond reproach when considered alone. But the combination of the two resulted, in effect, in eight hundred dirhams to be paid after sometime being exchanged for six hundred paid now in cash. However, three issues are involved because of which the above report along with its conclusion has evoked a lot of discussion:

Authenticity of the report itself.

Does intention of the parties to the transaction have a role in its characterization as *riba*?

Are all combinations of transactions ending up in a *riba*-like result to be declared unacceptable?

It is beyond the scope of this book to go into the details of this discussion that continues till date and has implications for some of the current practices in Islamic finance. Our purpose in recording it in this section is to prepare the reader for controversies that are bound to arise in human interpretations of divine guidance.

Among the Companions a few are reported to have taken the position that *riba* is confined to transactions involving time, i. e. deferred payment. They presumably relied on a reported saying of the Prophet: There is no *riba* except in deferment (Al-Bukhari, *Sahih*, *Kitab al Buyu‘ bab bay al dinar bi'l dinar nas'an*….). These Companions, Ibn Abbas being the most famous among them, appear to be denying the prohibition of unequal exchanges between any commodities as long as the exchange was on the spot. The issue has generated a lengthy discussion that can be followed through appropriate sources. (Badawi, 1964, pp. 99-158; Awad, 1978, pp. 4-18; Al-Misri, 1991, pp.167-171; Abul-Makarim, 1982, pp. 7-63). Most scholars have tried to reconcile the position with the *hadith* mentioning six specific commodities already studied above. That task becomes easier if we take into consideration the fact that the commodities mentioned in the *hadith* were serving as money in those days.

Another matter that caused some controversy was, what exactly is meant by the reported saying of the Prophet: Every loan that brings in some benefit is *Riba*. (Al-Misri, 1991, pp.274-75; Badawi, 1964, pp. 206-12; …..). Is it *riba* to get any benefit from something taken as a collateral against a loan, like a mortgaged piece of property? (Al-Mawsu‘a, 1992, Vol. 23, pp. 183-84, in the

article on *rahn*). Is it *riba* to take something in country A and give back its exact equivalent in country B?

> "It is reported about Zainab, wife of Abdullah ibn Mas 'ud, that she said: The Prophet of Allah gave me fifty-one wasaqs of Khayber dates and twenty wasaqs of barley. Then Asim bin 'Adi asked me, can I give you dates here and take your dates in Khayber? She said: Not till I enquire about it. She asked Umar who told her not to do that and said: What happens to liability (during the time period that elapses) between the two (taking possession in place A and delivering in place B)" [parentheses added by translator] {Badawi, 1964, p. 211, quoting Al-Mabsut by Sarakhsi, Vol. 14, pp. 35-37}.

It is possible to cite many more issues on which the Companions or those who succeeded them differed in interpreting the law of *riba.* Can gold jewelry be purchased by paying it's price in gold (coins or bullion) ? Or, must the gold paid be equal in weight to the gold jewelry? Can gold (or silver) jewelry be rented against payment in gold (or silver)? What about barter deals involving animals, does the law of *riba* prohibiting unequal exchanges apply to them? Each one of these issues engaged the Companions and those who followed them and attracted the attention of generations of jurists. But we generally end up with more than one viewpoint that established itself in different schools of Islamic jurisprudence. In subsequent history different practices in different regions in the world of Islam or in different periods of time often owe themselves to these early controversies.

It must be remembered, however, that the core of the law remained above controversy. There is not a single opinion validating giving a loan with the condition of repaying it after sometime with an excess added, whether the excess is fixed or variable.

Understanding of the Law of *Riba* Down the Ages

Two factors led the discussion on *riba* in the subsequent generations of jurists and scholars to focus on certain issues. First, they were dealing with what was largely a barter economy and one in which money was not standardized. Gold and silver used as medium of exchange had to be dealt with like other commodities in view of wide differences in quality and absence of a universally accepted rating authority. The same applied to coins if we consider the vast

regions and the long times involved. Secondly, the matter of excess charged on loans in cash or kind, characterized by jurists as *riba al-nasi'ah*, being prohibited having been already settled, they were naturally attracted to what they characterized as *riba al-fadl,* the issues surrounding barter.

A great debate ensued on whether the insistence on equality and simultaneity in exchange of certain commodities with similar ones was confined to the six commodities, including gold and silver, mentioned in the *hadith* or not. Those in favor of extending the ban to cover other commodities then debated the attributes that the commodities specified in the *hadith* shared so that the ban could be extended to other commodities sharing the same attributes. And lastly there were differences on which commodities are actually covered by the ban. All these debates that are found in the chapters dealing with trade (buyu') in the primary juristic works of second to sixth century hijri (8th to 12th century C.E.) are ably summarized in some works and need not detain us here. (Badawi, 1964, p. 166-99; Al-Misri, 1991, pp. 103-44)

As some issues got supplanted, partly due to saturation (there was nothing more to say!) and partly because of standardization of gold and silver coins and declining importance of barter, newer issues came to the fore. One such issue that emerged rather early and caused some discussion related to *fulus*. These were coins made of metals other than gold and silver, mostly copper and iron, introduced to meet the need for small change and/or to compensate for a shortage of gold and silver coins. (For their origin and place in the money system, see Al-Maqrizi, n.d, pp. 69-80; and Allouch, 1994). Scholars who treated them as proxy for gold and silver coins applied to them the same rules that applied to money proper. But others looked upon them as commodities neither included in the list specified in the *hadith* nor sharing the attributes of those commodities. As long as it was not a loan but a sale deed, it was, therefore, permitted to exchange *fulus* in unequal quantities and over time. This difference of opinion, recorded with respective arguments in relevant sources (Awad, 1980, pp.228-29) led scholars later on to a similar controversy relating to paper currency. It is not surprising, however, that this controversy was soon settled with near unanimity in favor of regarding paper currency as money like gold and silver coins—a view recently reaffirmed by the International Fiqh Academy of the Organization of the Islamic Conference (Resolution No: 9, 1407/1986, see Islamic Fiqh Academy, 2000, p.34). The reason is not far to seek: Unlike metallic *fulus*, treating paper money as 'commodities' is not credible at all.

Clause 396 of the Ottoman Majallah al Ahkam al Adliyah, relating to *bay' al wafa* blandly states: Just as the one who sells as per *wafa* has a right to return the price paid and take back the commodity sold, the buyer too has the right to return the commodity and get back the price (Al-Lubnani, 1986, p. 223, see also, clauses 118 & 119 on pp. 67-68); very simple indeed! Except when the 'commodity sold' is something from which you derive benefits as long as it is with you, like a house. The deal in that case amounts to 'lending' with an inflow of 'returns' over the period concerned. Nevertheless some jurists in the late Islamic centuries validated it 'considering the common practice and people's need for it' (Al-Mawsu'ah, 1986, Vol. 9, p. 260). The story would be repeated in the use of *twarruq* (Al-Mawsu'ah, 1984, pp. 147-48) for acquiring some cash now against more cash to be paid later, through credit-purchase of a commodity sold for cash at a price lower than the purchase price (Elgari, 2002; Al-Sharif, 2002; Sa'ati and Muhyuddin, 2002, pp.34-39; Hafiz, 2003; Al-Suweilem, 2003). With the banks doing all the buying and selling, *tawarruq* involves the customer (borrower?) in nothing more than a couple of signatures, leaving many wondering if that is what Islamic banking was all about!

The Issue of Bank Interest

Modern banking institutions based on interest first entered the world of Islam in the nineteenth century. The first few banks were established in Egypt, Turkey and India. They mostly dealt with the governments and foreigners. Their dealings with the native Muslim populations were few and far between, to begin with. But soon the situation started changing. Trade, especially external trade required services that only modern banks could provide. Some of these did not involve interest, and being a customer and having regular dealings with a bank was helpful. Many scholars, often faced with questions regarding dealing with banks, started worrying that Muslims keeping away from modern banks would mean all external and even most domestic trade passing into non-Muslim hands weakening the *Ummah*. There being no alternatives to modern banking institutions, some felt the need for having a fresh look at the law of *riba* with a view to finding a way out regarding the legitimacy of bank interest. Added to this was the pressure to have a second look on the interest credited to the saving accounts in the post offices, generally held by men of small means.

In Egypt the move for legitimizing bank interest was launched early in the twentieth century by Syed Rashid Rada who often cited his teacher and mentor, Mufti Muhammad Abdoh. (for details, see Badawi, 1964, pp.223-242)

In Turkey the proliferation of cash *waqfs* seems to have provided a bridge to modern banks. Keen to protect the capital while seeking a regular income for the *waqf*, resort was made to *mudarabah* (profit-sharing) with predetermined profits for the *waqf*. Middlemen exploited this 'need' by passing on to modern banks at higher interest rates what they got from cash *waqfs* at lower rates. (Cizakca, 2000, pp. 45-56)

In India the movement for legitimizing bank interest was spear-headed by a group of scholars and socials activists associated with Sir Syed Ahmad Khan who excluded bank interest from the prohibited *riba* (Khan, Sir Syed Ahmad, n.d, p. 243; see also, Fazlur-Rahman, 1958, pp. 24-25). An association was formed to promote the idea and a journal titled *Soodmand* was launched from Aligarh in 1925. A *fatwa* with the seal of approval by numerous religious scholars was also circulated (Fazlur-Rahman, 1958, pp.24-25). A lawyer by profession published a book on legitimacy of bank interest in 1936. (Suhail, 1999)

Muslims in general, however, did not swallow the idea even while dealing with banks out of necessity or for the sake of convenience. A section of them kept away from banks and tried to develop alternatives to help the community survive. These efforts got a fillip from the Muslim countries coming out of foreign rule one after another between 1945 (Indonesia) and 1964 (Algeria). It was no accident that the same period saw the advent of the theory of Islamic interest-free banking and some modest beginning in its practice. Simultaneously we find a number of institutions devoted to Islamic research reaffirming that bank interest was covered by the prohibition of *riba*. It is related to the core of the prohibited practice: loans with the condition of repayment with an excess over and above the principal. It is only towards the close of the twentieth century that a *fatwa* was, once again, issued in Egypt legitimizing, first the interest on investment certificates issued by the government and then bank interest.

The main consideration for the legitimizers seems to be two-fold: To afford the small man the possibility of safely keeping his/her savings as well as earning a modest return on it and secondly, to involve Muslims in business which was increasingly relying on banks for funding as well as for other services. Closely following the pragmatic considerations noted above is the claim that there is no moral case against bank interest, i. e. its prohibition has no rationale, it does not make sense in the contemporaneous situation (Saeed,

1996, p.145). For those who initiated the move for validating bank interest, it was no academic exercise. Anyone following the arguments of Sir Syed Ahmad Khan's associates or Rashid Rida and some of his contemporaries can see that the thing uppermost in their minds was the perceived difficulties in the contemporary application of *riba*-prohibition as interpreted by jurists which invalidated interest credited to post office saving accounts as well as banks' saving accounts. Problem solving and not understanding of the divine-intent was the main issue. By bringing the rationale issue to the fore later apologists for the movement sought to give it an academic flavor. There is no dichotomy between problem solving and divine intent behind Law. But giving priority to the understanding of the later, insofar as it is possible without referring to the problem, saves one from ad-hoc-ism and opportunism.

Arguments for Bank Interest

Let us now summarize the arguments of those who validate bank interest.

It is needed to afford savers a safe means of earning a return.

It is necessary for Muslims engaging in business.

It is an essential part of the modern system of money and finance without which the whole system will collapse.

Interest is the price of capital. If it is removed there is nothing to establish equilibrium between supply of capital and its demand.

Interest is necessary for efficient allocation of resources over time as in project evaluation.

It is not the *riba* prohibited in Islam. It is part of a system entirely different from the one in Arabia of which the prohibited *riba* formed a part (Fazlur Rahman, 1964, pp. 7-8, 37-41).

Modern bank interest does not violate norms of justice, so there is no moral case against interest.

It is not the *riba* prohibited in Islam. It is paid by rich banks to ordinary people in contrast to that paid by the poor to the rich lenders as in Arabia in olden days.

It is not the *riba* prohibited in Islam as it is related to commercial loans whereas the former related to consumption loans.

It is not the *riba* prohibited in Islam that related to very high rates of compound interest.

It is not the *riba* prohibited in Islam as bank deposits are not in the nature of loans made to banks but in the nature of capital supplied in *mudarabah*.

It is not the *riba* prohibited in Islam as it is only a predetermined rate of profit that the bank agrees to pay as an agent of the depositor who entrusted to it the task of profitable employment of the deposited capital.

Whatever force the first two arguments had enjoyed during the last quarter of the nineteenth century and the first half of the twentieth, when major efforts for legitimizing bank-interest were made, they are hardly convincing now. The proliferation of Islamic financial institutions, the widespread availability of mutual funds, and increasing dis-intermediation in financial markets has changed the situation. With reference to business there is hardly any problem with bank services other than those involving interest bearing credit facilities. As we shall see in the next chapter Islamic financial markets now offer several products and services catering to the two needs mentioned in these arguments.

As to the third reason, the myth of indispensability of interest had been shattered even before the advent of Islamic interest-free banking. Adequate literature is available to convince that the economy can function without interest. (Siddiqi, 1981, pp. 64-66; Siddiqi, 1983a, pp. 167-76; Zarqa, 1982; Chapra, 1985, pp.107-39; Khan & Mirakhor, 1987 pp. 125-39; IIBI, 1995).

Regarding the argument about interest being necessary to equilibrate the supply and demand of capital, one has to be clear about what is meant by capital. Obviously it is money capital and not capital goods, like machines etc., that are referred to in this claim. Interest is relevant only insofar as business acquires liquidity through borrowing. That happens only to be one of the many sources of capital, the others being self-financing and the stock market. The rate of interest charged by the commercial banks is governed by the rate announced by the central bank (the Federal Reserve Bank in case of United States). That crucial rate is largely a policy determined variable (Pivetti, 1991, p.135) and not a rate determined by supply and demand. What supply and demand determine is the rentals charged for capital goods like machinery.

As a matter of fact there are two markets for money capital in a modern economy, the bond market and the equity market. The role of interest in

establishing an equilibrium, insofar as there is a role, which we doubt, would be confined to the bond market only. The rate of interest free of intervention by policy makers would, according to economic theory, be determined by the rate of return in the real economy. It is this rate of return that is reflected by the prospective rate of profit in the equity market (which contains a risk premium too). This rate rather than the largely policy determined rate of interest in the bond market is crucial for equilibrating the capital market.

The fifth argument about the need for rate of interest in allocation of resources over time is also based on confusion between rate of return and the rate of interest. What is needed for efficient allocation of resources over time is a rate at which to discount the future cash flows from a project. '..the discount rate and the interest rate are two distinctly different things. Discounting prospective cash flows of projects promotes efficiency in investment and is quite acceptable Islamically. Discounting may be based entirely on rates of return in an Islamic economy which abolishes interest'. (Zarqa, 1983, pp. 228-29)

The sixth argument, the assertion that ' the bank interest of today is a separate kind of system' (Fazlur Rahman, 1964, pp. 7-8) is a partial truth. It does make a point that modern bank interest is somewhat different from *riba* as prevalent in seventh century Arabia. But it does not prove that it is totally different. It does not face the fact that modern bank interest shares with *riba* the crucial feature of granting to the lender an excess over and above the sum lent.

Bank interest of today shares crucial features with *riba* of the old times. Because it is there it permeates the whole of the economy, the consumption sector as well as the production sector. It cannot discriminate between the poor and the rich. It still entertains the possibility of compounding resulting in the very situation which is ascribed to 'doubling and redoubling' feature of the prohibited *riba.* It takes little imagination to conclude 'that the continual payment of interest and compound interest is arithmetically as well as practically impossible' (Kennedy, 1990, p.13). Look at the interest rates applied to credit card debts and similar phenomena forcing many states in the US to revive usury laws. Look at the third world debts, some of which had to be written off. Also consider the consequences of the fact that there is a net outflow of capital from the poor countries because of the servicing of loans contracted decades ago (Schaeffer, 2003, p.109). In an environment which does not guarantee positive returns to employment of money capital in business

enterprise, interest does precisely the same for money loans, and that too every year, all the time. The next point, that modern bank interest does not violate norms of justice so there is no moral case against it, is similar to the one we discussed above. We have also discussed it above in the context of the Quranic verse 2: 279. The question of fairness of bank interest is taken up again at the macroeconomic level in the fourth chapter.

At the microeconomic level we focus on the relationship between the holder of a saving account and the bank. But we cannot evaluate the fairness or otherwise of what goes on between these two parties without bringing into picture those who borrow from the bank. It is the tripartite relationship between the depositor, the bank and the loan-financed entrepreneur that has to be looked at as an integrated process.

Does the payment of interest on saving deposits pass the tests of equality and reciprocity so that we can declare it to be just? It does not. There is no equality between what is deposited and what is received back by the depositor. The depositor receives an added amount over and above the amount he/she put in.

The transaction also fails the test of reciprocity. But here the situation is more complicated as we cannot judge reciprocity without bringing into picture those to whom the bank is lending the money deposited. We have to look at the source of the excess over principal in the relation between the bank and the borrower, before we look at the source of the excess over principal in the deal between the bank and the depositor. There is no reciprocity between bank and borrower. The borrower is obliged to pay to the bank an extra amount, along with the amount the bank had given to it. The excess over principal that is guaranteed to the bank is not guaranteed to the borrower. It is a particular institution that gives guaranteed return to the bank, the institution of interest backed by the force of law. The environment of productive enterprise does not guarantee generation of a surplus on using money capital.

Since the relation between bank and depositor is based on that between bank and those borrowing from it, we cannot say that it qualifies on the criterion of reciprocity. Insofar as a just relationship requires equality and reciprocity between parties to the relationship, the relationships between the bank and borrower as well as that between bank and depositor into interest bearing accounts are not just relationships. They violate the norms of justice.

There is a strong moral case against interest based on the injustice it does to the borrowers and the damage it does to society. The social case against interest will be discussed in the fourth chapter. Here we shall only concern ourselves with the moral case against interest insofar as individual borrowers are concerned.

An individual borrows either for meeting consumption needs or for doing business. Taking consumption first we can make further distinction between basic and urgent needs and the need for consumer durables. No body can be forced to lend. But demanding an excess payment over and above the principal lent to a person in need is unacceptable on the ground that there is no possibility of the sum lent producing a surplus out of which interest could be paid. They can hardly be ascribed to the lender as they are rooted in the needs of the borrower.

In the case of consumer durables the benefits derived are more tangible and may be amenable to some sort of assessment. Loans for purchase of consumer durables like a car or a refrigerator may be regarded as an investment increasing his/her productivity, hence his/her income earning capacity. Something akin to profit is available in this case. As we shall see in the fifth chapter, Islamic financial instruments based on *murabahah* or leasing provide a better way of financing consumer durables than the one based on interest.

When it comes to production loans the injustice lies in not sharing the risks attending on profit making yet claiming a share in it. This injustice is further compounded by refusal to share the losses if and when they occur and insisting on guaranteed return of capital. Our environment does not guarantee profitability of all ventures. It does not guarantee even equality between inputs and outputs which may very well be less, implying losses. Money capital cannot, therefore, be assured of a positive return merely on the basis of being used in production.

The eighth argument refers to the contemporary phenomenon that a very large proportion of depositors into saving accounts in banks are people of small means, whereas banks themselves are rich institutions. It is not a case of the rich lender squeezing out the poor borrower. The savers are merely getting a small fraction of what the banks earn by using their savings. But this part of the story must be considered along with how the banks are making money by using these savings. They do so on the basis of an unjust arrangement as we have seen

above. The imposition of interest cost on producers irrespective of the actual value-productivity of borrowed capital has consequences for the economy affecting the rich as well as the poor. The interest credited to the small man's saving accounts does not come out of the rich banks' wealth. It comes out of the pockets of all members of society, rich as well as poor, who must pay a higher price for goods and services due to interest charged on all loans to producers irrespective of the actual productivity of any particular loan. The institution of interest may also cause greater unemployment than would obtain under a financial system based largely on profit-sharing further damaging the 'small man'.

That *riba* does not apply to interest charged on commercial loans as they did not exist at the time *riba* was prohibited, is based on a false claim. Commercial loans with interest did exist in seventh century Arabia. In fact they constituted a majority as we have seen in discussing the *riba* owed to Abbas bin Abdul Muttalib and annulled by the Prophet during his last Haj in the 10th year of hijrah. It is the legitimacy of interest on commercial loans which leaders of the opposition in Makkah tried to 'prove' by their 'argument' that trade is like *riba*[6].

The tenth argument is based on misunderstandings related to the system obtaining in seventh century Arabia as well as to that obtaining now. There is little evidence to the effect that it was the doubling and redoubling nature of *riba* in the Arabia of seventh century that led to its prohibition by Islam. The refutation of this particular interpretation of the Quranic verse 3:130 is well articulated in the relevant literature and need not be repeated here. (Al-Misri, 1996, pp. 40-41)

Characterizing bank deposits as money capital given to the working partner in a sleeping partnership (*mudarabah*) is against the notion of *mudarabah*. Bank deposits are guaranteed whereas *mudarabah* capital is vulnerable to losses. A positive return to *mudarabah* capital would accrue if and only if the use of capital by the business parties obtaining capital from bank make profits. No such condition attaches to the accrual of interest on bank deposits, they always get it. Pooling of deposits, diversification of investments, good management of risk, etc. cannot change the non-contingent nature of contractual interests on bank deposits.

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[6] Historical references can be found in Fazlur Rahman, 1958.

It is claimed that banks invest depositors' money as their agents and what they undertake to pay to the depositors is profits of doing business. Only the rate of these profits is contractually fixed in order to safeguard depositors' interests and prevent cheating by banks. It is difficult to accept this claim, for a number of reasons. First, agents are paid by their principals not the other way round. Secondly, banks do not directly engage in business, they lend money on interest. So the returns accruing to depositors could only be part of the interest banks are earning. They are not profits. And lastly, it is not in the nature of profits per cent of capital to be contractually fixed. As economic theory has it, profits are a residual, a surplus determined *post facto* and could very well be negative. As argued by Mahmoud Abu-Saud, regarding banks as agents of the depositors is entirely untenable in view of guarantee of the capital by the bank. (Abu-Saud, 1986, pp.21-22, see also the Arabic section of the same tract, pp. 22-23).

None of the 'arguments' claiming bank interest to be different from the *riba* prohibited in Islam or justifying it otherwise is convincing. The fact of the matter remains that people argue in favor of bank interest because, (1) they feel the need for some safe avenue for profitably parking their savings and, (2) they think modern system of banking and finance can not function without it. We shall therefore proceed, in the next chapter, to report the recent developments in the theory and practice of Islamic banking and finance. With reference to the first point it will be appropriate to examine, as we do in the next chapter, what Islamic finance as currently practiced has been able to offer. That chapter and the one that follows it should be able to convince that an interest-free Islamic financial system can function and function well.

Islamic financial institutions have yet to seize the market from the grips of interest, and they are not going to do so in the foreseeable future. But they are providing the common man some products that about meets their needs. Also, they have shown enough resilience to instill hopes that they will play an increasing role in shaping man's financial environment in the decades to come.

Conclusions

We have seen how the Quran has unambiguously prohibited *riba.* The *sunnah* further clarifies the concept and scope of *riba* and its prohibition by its application to barter and exchange of money for money. Despite some controversy in application, the core idea was held unanimously throughout

Islamic history. This idea related to the excess charged over the principal in case of a loan, that it was *riba*. Bank interest is *riba*. Those in modern times trying to legitimize bank interest by arguing that is was different, could not prove their case. In fact their focus was meeting the banking needs of Muslims. But these are now being met by Islamic banks, as we proceed to argue in the next chapter.

CHAPTER 3

ECONOMY WITHOUT INTEREST

In this chapter we focus on what would the prohibition of *riba/*bank-interest do to a modern economy. How can a modern economy function without interest? How financial intermediation takes place in an interest-free environment? What alternatives are available to interest bearing loans in Islamic finance? Which institutions would help mobilize savings and channel them to users? How conventional banks and non-bank financial institutions may be restructured on an interest-free basis so as to function in accordance with *shariah*? Is it possible to have a functioning stock exchange in an Islamic financial environment? What will make capital flow across borders and how international finance will look like?

Fortunately for us, it will not be mere speculative thinking. Some of these questions started being asked half a century before when they became relevant for Muslim peoples gaining independence and taking charge of managing their economies. Not only we have some theoretical literature accumulated over the period but also some empirical data. We will draw upon the operational details of interest-free finance in the private as well as the public sector in a number of countries during the last thirty years of its practice. In this context we will also study inter-Islamic financial cooperation. Our discussion concludes that Islamic finance is capable of meeting the variegated needs of a modern economy.

Liability Side of an Islamic Bank

The first step in the theory of Islamic banking and finance was to replace rate of interest by profit-sharing - the two-tier *mudarabah* model. It was thought that the liability side would have deposits on the basis of *mudarabah* as well as funds entrusted to the bank, with the permission to use but payable on demand. The assets side was to comprise funds given to business enterprise on the basis of profit-sharing or partnership. But as practice started this simple model was reinforced by admitting, on the assets side, some modes of financing that created debts. As at the present, Islamic banks have two kinds of liability: demand deposits in the nature of loans to the bank and investment deposits. The former need not detain us as it is like the current accounts in conventional

banks, guarantee of paying back the principal on demand but no profits. It is to be noted, however, that many Islamic banks have saving accounts as distinct from current accounts. Unlike current accounts, no checks can be drawn on saving accounts, transactions are to be recorded in a pass-book issued to the depositor. Saving accounts are guaranteed and carry no dividends (Ahmad, 1997a, p. 85; Salama, 1990, pp.179-80). But some saving deposits carry the permission of their being used by the bank. These are treated like investment accounts and get some dividend (Ahmad, 1997a, p. 116). In the case of the Bank Islam Malaysia Berhad 'the Bank may at its absolute discretion reward the customer by returning a portion of the profits generated from the use of their funds from time to time' even though these saving accounts are fully guaranteed with respect to their capital. (Ismail, 1990, pp. 194-95; Lewis and Algaoud, 2001, p.128).

Investment accounts are of a variety of types as to their time horizon and the authority vested in the bank with respect to their profitable use. Those committed for longer periods of time may be promised higher percentages of the profits realized through their use. The large deposits made with certain specific instructions as to their profitable employment may be treated differently than the ordinary investment accounts which merge into a large pool of similar accounts (BMA, 2002, p.9). There is, generally speaking, no constraint on the intermediary as to how to employ this pool of deposits into profit-making activity. But the bank is bound by the terms of contract insofar as the specific (restricted) investment accounts are concerned. All investment accounts carry limited liability, insofar as the account holder is concerned (Siddiqi, 1983a, p.40). In the beginning demand and saving accounts constituted a majority of bank accounts but these gradually declined, investment accounts of all types taken together currently constitute majority of deposits in the Islamic banks (Ahmad, 1997a, pp.116-17). This indicates growing confidence of the depositor community in the ability of Islamic financial institutions to generate competitive rates of return.

Islamic banks can also mobilize savings for investment by selling investment deposit certificates. These have the advantage of being marketable. The holder can liquidate them whenever he/she likes, but the funds would continue to be with the bank till the maturity of the certificates. A number of instruments have been designed to mobilize savings from individuals and institutions. (El-Hennawi, 1990; Ahmed, 1995; Ahmad, 1997b; Hamoud, 1998, pp.71-98; Kahf, 2000, especially pp.104-10).

Capital Protection

It may be considered that the *mudarabah* contract between a small depositor into an investment account and an Islamic bank has no exact parallel in the classical *fiqh* literature. Two points of departure from the primitive model of *al-mudarib-yudarib*[7] deserve attention: First, the vast possibilities of diversification, risk management and avoidance of loss of capital the modern rule-bound and supervised environment of banking provides and second, the need of the small saver in an inflation-prone economy to protect at least the nominal value of his/her savings while investing it for profit. This need is especially pertinent in circumstances when direct business or one to one *mudarabah* or *shirkah* is no longer a practical option for most of the people. Lastly, the small saver has little means to have the information necessary to monitor the banks or to try to choose between them on the basis of their performance. Information is costly and performance reports difficult to evaluate. When the model of primitive one to ones *mudarabah* is adapted to define the relationship between a billion dollar bank and a depositor of small means, a qualitative change may be involved.

Can depositors into the investment accounts of the Islamic banks be guaranteed the repayment of what they deposited, i.e. their capital? Should they be given such a guarantee? If yes, who should provide the guarantee, the bank or any third party, e.g. the central bank or the state? Mainstream Islamic banking does not entertain such a possibility. The reason lies in the classical *fiqh* literature being almost unanimous in rejecting the idea of guaranteeing the capital in a *mudarabah* contract. However the Iranian banks working under the 1983 Law for Usury-Free Banking do guarantee these deposits (see Article 4 in Bank Markazi, 1983), finding a way to do so in the Shia schools of *fiqh* (Baqir al-Sadr, 1973, pp.184-204). But such a guarantee is bound to affect the banks' dealings with its fund-users, as we shall see below. Iranian banks tend to protect themselves against any possibility of losses even in sharing based contracts. The idea of third party guarantee had been floated with respect to investment certificates (Kahf, 1989), but so far it has been applied in a very limited context (Khairallah, 1994, p.97; See also, Islamic Fiqh Academy, 2000, pp. 63-65) Recently the idea has been resurrected with respect to investment deposits too. But practice in mainstream Islamic banking remains what it was since day one, i.e. no guarantee for capital in investment accounts or investment certificates.

[7] *Mudarabah* done by one who obtained capital on *mudarabah*.

Bank Islam Malaysia Berhad does, however, market certificates, the NIDs, whose principal is guaranteed. Some of the profit-sharing accounts also promise retirees 'no more worries about how you will be supporting yourself…'(http://www.bankislam.com.my).

Another reason for the lukewarm response by the academics to the idea of guaranteeing investment deposits is the danger of adverse selection associated with it. Without such a guarantee savers are expected to do their best in deciding where to put their money. In a competitive environment the best performing intermediaries will attract more funds. A guarantee will make people lax and indifferent to monitoring the performance of the intermediaries. If a guarantee comes from a third party like the state, even the intermediaries' performance will be affected. They will tend to take greater risks in investing depositors' money as happened with Savings and Loan societies in USA and Credit Lyonnais in France.

The need for not exposing investment account holders to losses in practice, despite their being exposed to it in theory, was seen by writers on Islamic banking since very early days (Siddiqi, 1983a, pp. 50-51; 136 fn; Chapra, 1985, p. 128; 144 fn 50). These scholars suggested collective insurance through building loss-compensating reserves. The Jordan Islamic Bank adopted this approach (Zarqa, 2001). Current thinking favors a more formal commitment (Khan, 2003). Institutional arrangements involving the community of Islamic bankers (effectively meaning their share-holders), the regulatory authorities and the depositors into investment accounts themselves, can secure the desired result without affecting the core concept of Islamic banking that makes profits contingent on facing uncertainty and bearing risk. The central bank, or the appropriate regulatory authority in a country, seems to be the best choice for arranging and implementing the guarantee of the principal in case of investment deposits (and investment certificates). Due care will have to be taken that such a guarantee is confined to the small saver and the rich do not have access to it. It should also be very clear that we are concerned with preventing losses, not guaranteeing a positive return. The question is: Is it possible to look at the issue as a matter of public policy, *siyasah shar'iyah*, rather than an issue of justice in transaction, in view of the social benefits at stake, e.g. supply of savings and survival of people with low incomes?

While the theory of Islamic finance has still to mature and gain in clarity on this issue, products are being marketed which seek to 'provide a non-interest

based investment, capital protection and liquidity' (vide NCB International Trade Fund, on <http://www.alahli.com> '…capital protection has been achieved through allocating funds under management to a combination of secured fixed term *murabahah* contracts and *shariah*-compliant share purchase agreements' (Archer and Karim, 2002, p.139). Certificates backed by debt-based assets such as *ijarah* and *salam* are also on sale in the Gulf area. (BMA, 2002, pp.72-78)

Assets of an Islamic Bank

Assets of an Islamic bank can, in the first instance, be divided in two categories: those based on sharing and those resulting into a debt owed to the bank. Both are based on some contracts mentioned in classical *fiqh* literature. This is a great help in standardizing deals and eliciting customer confidence. Nevertheless it is necessary to go beyond terminologies into specifics as the same term may refer to different contracts in different parts of the world. A third kind of contract rooted in classical *fiqh* sometime invoked in the context of Islamic finance is *wakalah* or agency. Current practice also includes, to a limited extent, interest-free loans. In case of institutional lending, a small service charge is added to meet the administrative costs of the transaction.

Notice must also be taken of the possibility of an Islamic bank directly engaging into business. In that case the enterprise is fully owned by the bank and managed by its representatives. The entire profits of the enterprise accrue to it and it bears the losses if and when they occur. This is practiced by some Islamic banks in the Gulf area where they are permitted to do so by licenses specially granted to them. The bank can do it directly or, as is the practice more often, through a fully owned subsidiary company or agent.

Sharing Based Modes of Finance

Musharakah, *mudarabah*, *muzara'ah* and *musaqat* are the sharing based contracts discussed in the classical *fiqh* literature which have been adapted as modes of financing in recent practice of Islamic banking. We take them one by one.

Musharakah, also known as *shirkah*, is partnership. It envisages both or all parties to the contract putting in some capital. Each partner has a right to participate in decision-making, i.e. management of the enterprise. But there is

no bar on this right not being exercised or being transferred to another partner. This provision makes *musharakah* contract flexible enough to be adapted to financial relationships. Profit-sharing rules are subject to negotiation but have to be unanimously adopted. However when adapted to be applicable to joint stock companies with very large number of partners (share-holders), this provision of classical *fiqh* got translated into majority rule of decision making. As regards losses, they are defined as erosion of capital and have to be borne in proportion of capitals put in. No negotiations are allowed. These details technically belong to a particular type of partnership as defined in classical *fiqh*---*shirkah* '*anan*. Other types are not very relevant for our study of current practice of Islamic banking and can be ignored. Details relating to '*anan* type of partnership can be studied through appropriate sources. (Siddiqi, 1985)

Banks entering into partnership with business and participating in management does not quite fit in the British-type commercial banking most of the Muslim countries had inherited from their colonial masters. It does have a place, however, in the universal type of banking in vogue in continental Europe. Islamic banks seem to have learnt doing so partly from their own experience. As reported about the Faisal Islamic Bank in Sudan, a switch over from *mudarabah*-financing, in which the financier can not interfere in day-to-day management of the enterprise it finances, to partnership giving the Islamic bank the right to oversee management, improved performance and profitability (Mudawi, 1985). Partnership as currently practiced by Islamic banks involves putting their representatives on to the board of directors of the companies they are financing.

Mudarabah or sleeping partnership in which the financier cannot interfere in management except when there is a clear violation of the terms of agreement, is easier to practice than *musharakah*. But due to obvious moral hazard problems (Khan, 1987, pp. 88-91; Kazarian, 1991, pp. 111-12) and the fact that there are no laws protecting the financier's interest in a loss sustaining enterprise, we find that the two occupy about the same place in 'Financing by Modes, 1994-96 Averages' (Iqbal, Ahmad, and Khan, 1998, p. 28). It is intriguing to note, however, that the incidence of *musharakah* shot up to three times that of *mudarabah* in 1997 (IAIB, n.d, p.15). No definitive study has focused on the reasons and it is difficult even to surmise if this indicates a new trend or not.

The simple *mudarabah* contract provides for a once for all fixing of the ratio in which the entrepreneur will share the profits realized on the use of the capital provided by the bank for a particular project. It also envisages a single ratio of profit-sharing irrespective of the volume or percentage of actually realized profits. Theoreticians have suggested that the incentive of the working partner, the entrepreneur, can be boosted by raising the ratio of sharing in its favor as the rate of profit per unit of capital rises beyond a certain level (Kazarian, 1991, p 118-30). In other words, a graded scale of ratios of sharing may be more conducive to higher efforts and better performance, resulting in higher productivity that is a social good besides being advantageous to both parties to the contract. We do not have any evidence as to whether the idea has been put to practice or not.

A *mudarabah* contract does not provide for a collateral as the return of capital is not guaranteed but contingent on success of the enterprise financed. However the working partner does become liable if and when it violates the terms of the contract. It also becomes liable in cases of proven negligence or deliberate mismanagement. Could a collateral be demanded in view of these possibilities, to be invoked in these eventualities only? The idea is yet to be examined, but many Iranian banks are reported to demand collaterals against financing based on *mudarabah* or *musharakah.* (Yasseri, 2002, p.165)

In principle, entrepreneurs being financed on the basis of *mudarabah* or *musharaka* cannot be obliged to guarantee a positive return to the financing bank irrespective of the actual outcome of the enterprise. This principle is observed everywhere except in Iran. But this practice of guaranteeing a return is not recognized in Iranian law and the Iranian central bank actually penalizes such a practice. (Yasseri, 2002, pp. 165-166)

Muzara'ah translated literally would mean sharecropping. But we have no intention to discuss it, not being relevant to our subject. What makes *muzara'ah* relevant is financing agriculture the way one would extend *mudarabah*-finance to trade or manufacture-providing money capital on the condition of getting a share of the yield. It is the crop itself and not the surplus after meeting the cost that is shared in *muzara'ah*. Iran tried to make it a major instrument for financing agriculture (Bank Markazi, 1983, Article 17) *Musaqat* is like *musharakah* applied to horticulture. Two parties, or several, participate in financing an orchard as well as in managing it and they share the yield. (Sundararajan and Erico, 2002, p.21)

Trade-Based Modes of Financing

These are the ones resulting in debt creation. In all these transactions there is an exchange of cash for commodity, but one of these, either cash or the commodity, is deferred. What is deferred becomes a 'loan', be it in cash or kind. Once a loan, its face value cannot be increased as that would be *riba*. These modes are based on certain contracts discussed in the classical *fiqh* literature. They have also been in use for more than a thousand years. These two features of these contracts are very important as they provide a point of reference and help in standardization. Also their practice in different times and places has produced a variety of interpretation that enriches the recent attempts at their adaptation to the needs of a modern society. We begin with the modes of financing that result in the financed party owing a sum of money to the bank at some future date. These are *murabahah*, *bay'mu'ajjal*, installment sale and *ijarah* (leasing).

Murabahah

Murabahah, as practiced by Islamic financial institutions, is re-sale of a commodity with a mark-up on purchase price. Alternatively we can describe it as cost-plus. The financing bank sells to a customer the commodity the customer needs and the customer undertakes to pay the (higher than current market) price at a future date. The bank purchases the desired commodity only after getting a commitment from the customer to buy it. Part of this commitment is the price to be paid by the customer which is higher than the market price at which the bank buys it, by a certain amount or percentage. The contracted price cannot be increased even if there is a delay in payment by the customer. The customer's obligation to pay is not affected by what becomes of the thing purchased. For example, if it was raw material purchased to manufacture something and sell at a profit, but there is a loss in the business enterprise, the customer is still bound by the contract to pay the price at the agreed time. The price owed to the financier is treated as a loan would have been treated. The debt arising from a credit purchase, as in the current practice of *murabahah*, and the debt arising from borrowing cash are at par, insofar as the obligation to repay is concerned. As we see in a subsequent chapter focusing on the macroeconomics of *murabahah*-generated debts, there are crucial differences between the two kinds of debts. But in the context of our analysis in this chapter the important thing to note is the difference in profit-sharing finance and *murabahah* finance: the former creates no debts, the later always does.

Murabahah financing leaves the entire results of the use of the commodity financed in productive enterprise for the user, the owner of the enterprise. It is the one to bear losses, if any, and it is the one who owns all the profits. The financier has no share in the profits of a *murabahah*-financed enterprise. That sounds good for the incentive to work and manage the enterprise to the best of ones capacity. No agency problems and no moral hazard, as we encountered in the otherwise superior profit-sharing finance.

Murabahah Versus Interest

There is no injustice involved in *murabahah*-financing insofar as the relationship between the financier and the entrepreneur-buyer-on-credit is concerned. On that count it is superior to the financing arrangement based on interest. The financier is financing not a venture of uncertain results but the acquisition of a commodity of acknowledged utility and known current price. The mark-up on current price is tacked on the commodity, whereas in interest-based borrowing it is tacked on money capital (the principal). By converting its money capital into a commodity the financier has already given up liquidity and taken the risks associated with owning a real asset, e.g. a fall in its market price, destruction due to natural causes or theft, etc. He/she also takes the risks associated with relying on the other party's promise to buy, like the risk of bankruptcy of the would-be buyer or backing down on its promise to buy. Also, by selling on credit the financier is taking the risk of default by the buyer as well as forgoing any other opportunities of using the money that could have arisen as time passes. Time, which is not recognized by *shariah* as a basis of claiming an excess over principal when making a money loan, becomes part of the justification for a mark-up in credit sale (Khan, 1995, pp. 160-63). The fact that *shariah* does not allow any further increase in the contracted price, should more time elapse before the actual payment is made, clearly demonstrates that there is no price for the mere passage of time involving a sum of money.

The twin norms of justice in transactions, equivalence and reciprocity, which we found violated in interest-based lending, are not violated in sale on credit with a mark-up on current price. There is perceived equivalence between the commodity received by the buyer and the price received by the seller, as is the case in voluntary exchanges between commodity on one side and money on the other. Reciprocity inheres in the seller's advantage of a mark-up (attached to which are the risks mentioned above) being matched by the buyer's advantage of getting the time and opportunity of using the commodity ahead of paying the

price. As we have already seen above, no such claim can be made about exchanging money now for more money in future. Perception of equality is acceptable in place of objective equality in exchange of dissimilar things, as money and commodity, but it cannot be acceptable between the same things, i.e., in exchange of money for money. There it has to be measurable equality as there is no room for perception. There is no reciprocity either. What the lender gets is definite and known but what the borrower gets is neither definite nor known, should we consider the point of time the loan is repaid.

The Problem of Default

As we noted above financing by *murabahah* creates debts and with debts there is a possibility of default. It is therefore allowed to ask for a collateral. It could be a bank guarantee or pledging of property or the purchased asset itself. In practice a lien may be placed on the commodity itself if it is a durable good like machinery.

The possibility of delay in payment raises other questions too: How and when to penalize the defaulter and how and when to compensate the creditor? After a lengthy debate, practice has taken a variety of routes. The principle of penalizing the defaulter is universally accepted but the method of compensating the creditor is not, fearing it may open the door for *riba* (Saleh, 2002). But in case of a debtor with enough means to pay, some scholars favor the idea of obliging the debtor to compensate the creditor for losses sustained because of delay in payment (Al-Zarqa, 1996). But a compensation involving courts of law is hardly a 'solution' for financial institutions who prefer a mechanism that delivers automatically.

It is interesting to note that in the early days of practicing *murabahah* some institutions resorted to what can be aptly called sham-*murabahah*. Instead of buying the desired commodity and then selling it to the customer some financial institutions just issued a check in the name of the seller of the commodity indicated by the customer and handed it over to the customer after obtaining from him/her an IOU for a larger amount to be paid later. The Islamic Fiqh Academy disallowed the practice and issued guidelines for *murabahah* that are now generally observed. (Islamic Fiqh Academy, 2000, p.24; pp.86-87; p.104) It should also be noted that *shariah* advisors in Sudan do not consider the client's promise in *murabahah* to buy the commodity it ordered the Islamic

bank to supply, as binding. The practice of *murabahah* in Sudan is regulated according to this view. (Bunk al-Sudan, 2000, p.2 and p. 10)

Murabahah currently constitutes the bulk of operations by Islamic banks. In most cases they do it directly, i.e. buy the commodity desired by the client and resell it, 'simultaneously' (S&P, 2003, p. 6) to it at a higher but deferred price. But in some cases special agencies have been set up to take care of these operations (BMA, 2002, p. 48). As pointed out in the literature, the bank-subsidiary relations can be on bases other than agency too. A company could be specializing in *murabahah* operations while being funded on the basis of *mudarabah*. A *murabahah* company could also mobilize savings directly by selling *murabahah* certificates, but these certificates being debt instruments, could only be used for certain limited purposes like discharging other debts or serving as collaterals. That is the mainstream stance. But the Negotiable Islamic Deposit Certificate (NIDC) of Bank Islam in Malaysia is backed by *murabahah* based assets. (Archer and Karim, 2002, p.132)

Despite many 'improvements' over the way *murabahah* used to be practiced a decade ago there are a number of factors calling for continuing criticism emphasizing the need for further fine-tuning to bring it nearer to the ethos of Islamic finance. These criticisms center round the nearness of *murabahah* financing to conventional interest based financing. It is pointed out that real possession by the bank/seller hardly takes place and, in any case, the risks taken by the financier are, most of them if not all of them, insurable. It is easy, therefore to pass on the cost involved to the customer as part of the mark-up (Vogel and Hayes III, 1998, p.9. and p. 143; Warde, 2000, pp. 133-34). Secondly, *murabahah* is by its very nature focused on short-term financing. It is not capable of meeting the long-term needs of time-taking industrial projects, for example. In practice *murabahah* has been used mostly in financing trade. As a result of diverting most of its funds towards *murabahah*, Islamic financial institutions may be failing in their expected role of mobilizing resources for development of the countries and communities they are serving.

Since *murabahah* constitutes the bulk of Islamic financial institutions' operations, efforts are being made to standardize the practices involved. The Accounting and Auditing Organization for Islamic Financial Institutions. (AAIOFI) is playing a leading role in this regard (AAOIFI, 2002, pp.119-40).

Other Asset Based Instruments

Bay' Mu'ajjal is not very different from *murabahah*. It is sale on credit or deferred payment. The commodity is delivered now and the price is paid after some time. The price, higher than the spot price, must be determined now along with the date of payment. If it is preceded by the customer's desire/commitment to buy a certain commodity at a certain price, there is little to distinguish it from *murabahah*, except the obligation of the seller in *murabahah* to reveal the cost. Should the payment of price be in installments, it becomes an installment sale. Due to the way it is actually applied there, Iranian practice knows *murabahah* as installment sale. Currently it constitutes more than half of all bank financing as against one fifth financing based on *mudarabah* and *musharakah.* (Yasseri, 2002, p. 158)

Salam is the opposite of *bay'mu'ajjal*, price is paid now and the commodity purchased is delivered in future. The price paid is lower than what is expected (by the buyer, at least) at the time the commodity is to be delivered. During the Prophet's time it was generally applied to agricultural commodities. Modern Islamic finance has also adapted it for financing agriculture. It is listed in that category in the Iranian law as well as in the relevant rules issued by the State Bank of Pakistan. It has a modest share in bank financing in Sudan. (Bank of Sudan, 2001, p.41)

Applied to manufacture, *salam* becomes *istisna*'. It may be called a pre-paid order for some commodity. The buyer specifies the commodity in quality and quantity and the seller undertakes to deliver it at agreed dates. The seller may or may not be the one who actually manufactures the commodity. The payment may be all in the beginning, at the time contract is made, or in installments, over time. The delivery of goods too may be staggered over time. The *istisna*' contract has the potential of being used as a mode for financing industry including long-term projects. It is now being used for financing building schools and electrical power generation plants in Saudi Arabia. Al Rajhi Banking & Investment Corp. reported *istisna*' assets of about 2.5 billion riyals in year 2000 (Al Rajhi…, n.d., p.15). *Istisna*' financing ranked third, after *murabahah* and *mudarabah*, in Indonesian Islamic banking in the third quarter of 2002 (Bank Indonesia, 2003, p.1). Its incidence in Islamic Development Bank's project financing has also been steadily increasing over the years. In 2001-2002, it ranked first, followed by leasing, loans and installment sales (IDB, 2001-2002, p.22). It will be noted that *istisna'* and *salam* help redistribute

risks from those who do not want to take them or cannot afford to take them to those who can and wish to take them, expecting to gain thereby.

Ijarah in classical Islamic *fiqh* is sale of benefits, generally of a durable good. Its modern equivalent is leasing. Just as *murabahah*/*bay'mu'ajjal* has been adapted as a mode of financing the acquisition of goods, machinery, equipment, etc., leasing is used by Islamic financial institutions for enabling customers to use durable goods, equipments in productive enterprises without having to buy them. One can distinguish between operational lease in which there is no obligation of the lessee to buy the thing leased, and the lessor is responsible for its maintenance and insurance, and financial lease. A financial lease ends in the lessee acquiring the thing leased, generally at a nominal price and makes him/her responsible for insurance and maintenance. *Shariah* advisors disapprove financial lease but practitioners try to modify it by making the thing leased a free gift at the end and assuming the responsibility of maintenance and insurance but passing on the cost to the lessee. Nevertheless, the Islamic Fiqh Academy guidelines (Islamic Fiqh Academy, 2000, 253-55) have been helpful in making practice more *shariah*-compatible. (Moore, 1997, pp. 39-40 and pp.123-27)

Murabahah, *bay'mu'ajjal*, installment sale, *salam*, *istisna*' and leasing (*ijarah*) can be distinguished by the fact that in leasing the asset remains a property of the lessor, in our case the Islamic bank. In the other modes of financing listed above the ownership of the asset passes to the customer by virtue of a sale deed. In leasing it is a hire contract and not a sale contract. The customer, the lessee, pays a certain amount in cash, yearly or monthly, as the rent of the asset. Since the Islamic bank acquires the desired asset only when a client requests for it and commits to enter into a lease contract with the bank, it is possible for the bank to make a profit by setting the rent at a level that covers, over the life of the asset, the purchase price as well as a return commensurate with the current rate of mark-up in *murabahah*. That presumes that the lease is for a time long enough to cover the life of the asset. The banks are not interested in the asset itself so the contract generally provides for sale or gift of the asset to the lessee at the end of the contract period. When that sale price is nominal and agreed at the time of the lease contract, it becomes *ijara-wa-iqtina'*, or a lease ending up in the lessee owning the asset. Even though lacking approval by *shariah* advisory boards, that is the form generally in vogue as it is akin to *murabahah* and suits the banks' role as financial intermediaries. It is also a mode of finance suitable for consumer durables like cars and equipments

needed by some professionals, like x-ray machines and other medical equipment.

Islamic Banking in the Private Sector

The first dozen or so Islamic banks established in nineteen-seventies were all in the private sector. Even though they required special charters for operation, their share capital came from individuals. They were all in the Gulf area, Egypt and Sudan. Their numbers have increased manifold in the subsequent decades and they are found in almost every part of the world. The 1997 Directory of Islamic Banks and Financial Institutions has listed 194 institutions in 40 countries (IAIB, n.d., pp. 49-54). But this list includes state-sponsored institutions also.

Non Bank Islamic Financial Institutions

Practice has shown that there is a wide scope for non-bank financial institutions within the framework of Islamic finance. Some of these institutions are investment companies, mutual funds, insurance companies/ *takaful* companies, and special funds for old age pensions, retirement, etc. The stock market too occupies a unique place in this regard. Efforts are also on to develop money markets and markets for derivatives.

The important point to note in this connection is that interest, though currently involved, is not crucial to the functioning if these institutions. This is amply demonstrated by the rapid progress of non-bank Islamic financial institutions during the last two decades. We also observe that despite divergence between Islamic and conventional finance there is a lot of convergence too, a fact increasingly being appreciated in the national as well as international financial markets.

Islamic Investment Companies

The first few Islamic investment companies appeared in the early nineteen eighties pioneered by Dar al Mal al Islami, followed by the Dallah Al-Barakah group and other local initiatives. They operate as agents of those who entrust their funds to them for investing in profitable businesses, all the time observing *shariah* rules. They generally charge an initial management fee (a

small percentage of the capital in case of Dar al Mal) followed by a percentage of profits if and when they accrue.

Dar al Mal al-Islami sold 'shares' based on *mudarabah* between the buyer of the share as financier and the company as *mudarib*, working partner. Profits were calculated and distributed annually. There were no withdrawals but one could sell back the shares to the company itself at a price determined by the company according to its market capitalization. The funds so accumulated were mostly used in business directly managed by Dar al Mal subsidiaries. These funds were not used to buy shares on the stock market as they were found indirectly to be involving the company in *riba*. The investment companies launched by Dar al Mal al Islami had separate accounts. They too accepted funds on *mudarabah* basis and invested them in business using *mudarabah*, *musharakah*, *murabahah* and leasing contracts. They announced profits periodically but one could quit any time one liked forgoing the profits of the period not yet completed.

The pattern followed by Dallah Al-Barakah was a little different. Its subsidiaries, Al-Tawfeeq and Al-Amin, announced projects one could participate in, locking one's capital for the duration of the project and getting it back with the profit earned. Since these companies invested only in leasing and *murabahah* based ventures the expected profits could be announced in advance. Both these pioneer institutions continue offering the above mentioned financial products as well as some new ones as they absorb new ideas emerging in the Islamic financial industry. The pattern is repeated by new entrants into the business in many western countries as well as in other countries.

Islamic Mutual Funds

The first Islamic mutual funds appeared in mid- nineteen- eighties/ early nineteen-nineties. Many new entrants during the nineties were launched by conventional funds in order to meet the preferences of a section of their clients. There has been a great increase in the number and variety of Islamic mutual funds in the late nineteen-nineties due to the advantage of their near liquidity. Equity based mutual funds deal with shares. They build a diversified portfolio of stocks suited to the objectives of the fund: is it growth in value over time or is it income in the short run, etc. Funds are also distinguishable on the basis of their exposure to risk or their time horizon. Selection of companies whose shares are to be included in the portfolio is done after screening out those which

deal with goods and services not permitted in Islam, like liquor, gambling, etc. Another screening is done with reference to involvement of the company with interest. Any interest earned has to be assessed and the return to customer purified from it. Also commodities and not debts or cash should constitute the overwhelming majority of the assets of the company, the current threshold for debts being set at 33% (Valpey, 2002, p. 264; Elgari, 2002a, Elgari, 2000; Moore, 1997, pp. 80-81 and 190-92). Besides these negative criteria, a fund can also introduce certain positive criteria for including a company's shares in its portfolio, like production of basic-need items or serving a certain region, etc. Thus a certain fund in Malaysia would not have more than 10% of its assets outside the country (Ahmed, 2001, p.21). Another kind of funds deal in commodities or real estates. There are funds based on *salam* as well as those based on *ijara*/leasing. In recent years the rate of expansion of Islamic Mutual Funds, called Unit Trusts in Malaysia, may have surpassed the rate of expansion of Islamic Banks. One of the leading institutions in the field has been the National Commercial Bank of Saudi Arabia. (For more information, see <http://www.failaka.com>).

With the proliferation of Islamic mutual funds and other investment instruments, the industry realized the need for indexes specially designed for Islamic investors. 'The Dow Jones Islamic Market Indexes were created for people who wish to invest according to Islamic guidelines. The Indexes track *Shariah* compliant stocks from around the world..' The excluded 'Incompatible lines of business include: Alcohol, Pork-related products, Conventional financial services (banking, insurance, etc.), Entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.). *Shariah* scholars also do not advise investment in tobacco manufacturers or defence and weapons companies'. (www.dowjones.com/islamic)

Islamic Insurance/Takaful Companies

The need for insurance was felt as soon as Islamic banks started operations as some of them were trading in commodities across oceans, an activity not possible without insurance. The first Islamic insurance company to be launched was based in Khartoum and was to meet the insurance needs of the Faisal Islamic Bank, Sudan. That was in 1977. As of today, we have many companies offering general insurance and also *takaful* companies offering a substitute for life insurance on the bases of *mudarabah* and mutual cooperation. *Takaful* companies may be based on *mudarabah*, as in Malaysia and in some

countries in the Gulf or on *wakalah* (agency) as in case of Islamic Insurance Company, Jordan and the one launched by Bank Al-Jazeerah, Saudi Arabia. Some practices of the conventional insurance companies are adopted in the Malaysian model on the basis of custom (*urf*). Whatever the juridical basis approved by their *shariah* advisors, the essential features of all models of Islamic insurance/*takaful* remain the same: compensating premium paying subscribers in case they incur certain losses/damages without any interest-based activities being involved. A whole range of insurance products are now available from relevant Islamic financial institutions. (Moore, 1997, pp. 60-66)

Stocks, Options, Derivatives and Risk Management

Once the jurists characterized the sale and purchase of the shares of a large commercial or industrial establishment as the legitimate sale of a small, unspecified portion of a property, the road was clear for a 'market' for such shares. The emergence of joint stock companies with limited liability, examined and approved by jurists earlier than the spread of Islamic finance, further heightened the need for envisaging the functioning of the shares' markets in the Islamic framework. In the beginning the dominant consideration in the minds of those who ventured into the field was how to keep the stock market free of speculation. (Chapra, 1985a, pp. 95-100; 1985b; Metwally, 1984) But later other issues related to its efficient functioning in an Islamic framework also came into focus. (El-Din, 1996; 2002; Kia, 2001; Elgari, 1993; El-Ashker, 1995; Obaidullah, 2001)

Increasing volatility in the world markets for commodities, currencies and stocks greatly increased the risks involved in business and investment. Risk management in an Islamic financial environment, a topic hitherto neglected, became a major theme for research (Obaidullah and Wilson, 1999; Khan and Ahmed, 2001; Chapra and Ahmed, 2002). Securitization, an important tool of risk management, is easily possible in case of ownership-based assets like *ijarah* (leasing). Hedging, though sparsely practiced by Islamic financial institutions till now, offers great promises, calling for more research (Archer and Karim, 2002, pp. 190-92; pp. 185-86). Derivatives, especially options, have already received a fair amount of attention (Kamali, 1999; Obaidullah, 1998; 1999). Options have been found to be acceptable as instruments of risk management when these are in the form of stipulations in exchange contracts. It has been shown how the risk incurred by Islamic financial institutions in *murabahah* can be managed on the basis of *khiyar al-shart* (Obaidullah, 1999;

1998). Some see potential in derivatives (Kamali, 1999; Archer and Karim, 2002, pp. 186-88). Nothing is barred, it seems, as long as certain fundamentals of the Islamic approach to risk are kept in view. Among these: property rights come first, there can be no trade without ownership; Manage the risks you face but do not create risks artificially as a means of making profits; Do not involve interest, e.g. exchanging money now for an unequal amount of money later, whether certain or uncertain; Avoid all that is knowable but not known, describable but not described, etc. (the rule of thumb criterion for avoiding *gharar*). And, last but not the least, no prohibited commodities should be involved.

Some practical steps towards a stock market functioning in accordance with Islamic guidelines have been taken in Malaysia and Bahrain. Malaysia, by far the more advanced in this respect, also has an Islamic Inter-bank Money Market (IIMM) encompassing Islamic banks, Islamic insurance companies and the Islamic stock-broking houses.(Ahmad, 1997b, p.41, also pp. 63-72) There are a large number of companies whose shares are declared compatible with *shariah* and qualified for sale and purchase on the stock exchange. The central bank, Bank Negara Malaysia, is guided by the National Shariah Board, established in 1997, which decides what is compatible with *shariah*. Some of their decisions, like the one approving the launching in 1990 of *shahadat al dayn* (debt certificates) for sale and purchase is still controversial in other parts of the Islamic world. (Securities Commission, 2002)

Many Islamic financial instruments are traded on the Bahrain Stock Exchange in Manama, which has the highest concentration of offshore Islamic financial institutions. The Bahrain Monetary Agency has *shariah* advisors to help it discharge its supervisory functions.

Islamic Finance under State Sponsorship

In this section we study the story of Islamic finance under sponsorship of the state in Pakistan, Iran, Sudan, Malaysia and Bahrain. We begin with Malaysia.

Islamic Banking and Finance in South East Asia

Tabung Haji, the prototype Islamic financial institution in Malaysia, dates back to 1963. But there is nothing new to report till 1983 when the first full-

fledged Islamic commercial bank, the Bank Islam Malaysia Berhad (BIMB), was launched. Since then it has been an era of continuous activity despite the temporary setback to the Malaysian economy in the late nineteen-nineties. We have already noted some innovative initiatives in the previous sections.

'It is now mandatory for every licensed bank to offer Islamic financial products to retail customers through 'Islamic windows', (Archer and Karim, 2002, p. 132). Typical of a pluralistic society whose financial sector was long dominated by non-ethnic, non-Muslim elements, the Malaysian model is being emulated in the south-Asian region as a whole.

What exactly is the role played by the state? As compared to the three countries which preceded it in patronizing Islamic finance, Pakistan, Iran and Sudan, Malaysian state's role can be described more as enabling than promoting. All the relevant legislations are in the nature of facilitating interest-free Islamic financial activities not feasible in the legal framework that existed before the new legislation. No law is directed at disabling interest-based finance as in the case of the other three countries (Warde, 2000, pp. 123-28). May be a more proactive role by the state would now be justified in the name of inter-Islamic cooperation and integration but the net results of the three other attempts seem to justify the cautious gradual approach which also leans more heavily on the private sector.

Malaysian markets for Islamic financial products have been very innovative. But they have been also drawing lot of criticism. (Usmani, 2000). Malaysian markets have witnessed Islamic debt instruments, not only with guarantee of capital, but also with predetermined returns. These debt instruments have made use of questionable contracts such as *bay'al-inah* and *bay'al-dayn.* (Rosley and Sanusi, 1999)

Indonesia now has an Islamic banking industry supervised by Bank Indonesia. There is greater attention paid to the rural sector than in the neighboring Malaysia. Like Malaysia, Indonesia too has a National *Shariah* Council (Dewan Syariah, 2001) whose advice is followed by the central bank. Starting with Bank Muamalat Indonesia in 1992 which was later allowed to open branches, Indonesia had its second Islamic commercial bank in 1999, followed by introduction of other Islamic financial instruments in the market. 'During the period 1998 to 2001, *shariah* banking system has grown quite rapidly at about 74 percent annually (in terms of asset size)' (Bank Indonesia,

2001, p.5). Authorities seem to be aware of the need to make Islamic banking beneficial to everyone, including non-Muslims, if it has to establish itself in a competitive environment. (Bank Indonesia, 2001, p. 8)

The Thai Ministry of Finance has a 25 percent stake in Thailand Islamic Bank launched in 2002. There are already two other Thai banks which offer Islamic services through dedicated windows. (Islamic Banker, 2002, p. 27)

Malaysia, Indonesia, Brunei-Darussalam, the Philippines and Thailand, all have financial institutions free of interest catering mostly to the Muslim populations in the region. Their market penetration is increasing, although slowly. State sponsorship does help, but what is more important are private initiatives which are on the increase.

Islamic Finance in Bahrain

One of the first few countries in which Islamic banks were established (in 1978), Bahrain is trying its best to boost its status as a regional financial hub. It has a concentration of Islamic financial institutions in the area (BMA, 2002, p.18), with the state actively involved in the process, not only as regulator but also as promoter. 'The BMA is pioneering a series of new financial instruments designed to broaden the depth and liquidity of Islamic financial markets' (BMA, 2002, p. 72). These include leasing (*Ijarah*) securities and *Al Salam Sukuk* (Islamic short term securities). BMA also successfully marketed 'Islamic Leasing Certificates with a five-year maturity'. (BMA, 2002, p. 75)

Islamic Finance in Sudan

Private initiatives on Islamic finance in Sudan started in mid-nineteen-seventies before state patronage was extended to it in mid-nineteen-eighties. After a slow progress during the first decade, it picked up steam in the nineteen-nineties. It has recently acquired a renewed vigor. Interest is completely abolished and all financial transaction in private as well as public sector are restructured in accordance with *shariah* as interpreted by a council set up for this purpose.

Peculiar to Islamic banks in Sudan, demand deposits still constitute over 70% of the total deposits. But the strong point of Islamic finance in Sudan is *mudarabah* and *musharakah* making more than a third of all financing by

banks. (Bunk al-Sudan, 2001, p.41; Al-Jarhi and Hussein, 2002). *Murabahah* still dominates the scene, being responsible for two-fifth of all financing. The Bank of Sudan is also playing a more active role in introducing instruments for mobilizing resources for the public sector and for being used in monetary management in a financial environment now declared free of interest (Khair, 2000; Bunk al-Sudan, 2001, p. 12 and pp. 50-51).

Of the two financial instruments recently introduced in Sudan, GMC (Government *Musharakah* Certificate) is designed to mobilize private savings for public sector projects. Returns will depend on the performance of not any particular project but that of the public sector projects as a whole. The other, CMC (Central Bank *Musharakah* Certificate) is to serve as a tool of monetary policy, enabling the monetary authority to mop up excess liquidity from the market or inject more liquidity into it, as needed.

Laws have recently been enacted to regulate the securities market and the Islamic Stock Exchange, launched in 1994, is making good progress (www.winne.com/sudan/ginawi.htm).

Iran, Turkey

Iran's efforts to rid its economy from interest and manage the financial sector entirely on the basis of its 1983 Law of Usury-Free Banking were thwarted by the burden of financing the first Gulf war, the need for foreign loans as well as the large 'informal' sector. An ill-advised nationalization of the entire banking sector had already shut out any possible contribution by the private sector into the unprecedented task of reshaping a modern system of banking and finance in accordance with the teachings of Islam. The permissible rates of profits being set by decree in the absence of any signals from a market which was no longer free to do so, were not very helpful. There is a tendency to do outside the formal financial sector what would never have been approved formally-not a very enviable situation! (Warde, 2000, pp. 119-20).

A note worthy development in Iran is the financing of agriculture through *musharakah*, which gradually replaced *murabahah*---known as installment sale in Iran--- to reach 48% in 1997 (Sadr and Zamir, 2001, p.274).

Turkey, though far from being a state sponsoring Islamic finance, did facilitate, during the nineteen-eighties, the establishment of half a dozen

‘Special Finance Houses’ working as Islamic financial institutions do elsewhere. Working under full supervision of the central bank, they are doing well ‘…Islamically structured products are gaining popularity with finance directors in Turkey. In 1996…the Istanbul Municipal Gas Distribution Company used *ijarah* facilities twice to finance the purchase of pipelines…’. (Moore, 1997, 238-40)

Elsewhere, the Arab Albanian Bank has been functioning for some years (IAIB, n.d., p.24). The Bosnia Bank International, established at Sarajevo in 2000, is also working well. (http://www.fba.ba)

Pakistan, Bangladesh

The state of Pakistan was constitutionally committed to eliminate *riba* from the economy. But the first serious expression of that commitment came only in 1980 in the form of the Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy. During the quarter century that has elapsed since then there have been many efforts at rule making but little by way of private initiative in making the practice of Islamic finance possible. The fact that the country is heavily dependent on borrowing, domestic as well as foreign, has compounded the difficulties. The earlier global approach of trying to do all things together, and to do them sooner than later, seems to be giving way to a more gradual, step-by-step way of introducing Islamic finance and making the private sector play a more active role. (State Bank of Pakistan, 2003)

There are a number of *Mudarabas*-similar to *Muqarada* bonds elsewhere - traded on the Karachi Stock Exchange. Other private initiatives are also being encouraged, resulting in the first indigenous privately owned commercial bank operating in accordance with *shariah* as interpreted by a board of advisors---the Meezan Bank. (www.meezanbank.com)

Bangladesh had its first few Islamic banks since the nineteen-eighties. The Bangladesh government had participated in establishing the first Islamic bank in 1983 by subscribing five per cent share in its paid-up capital (Sarkar, 2000). But the state is now reported to be taking greater interest in their progress, as evidenced by the (under process) new Islamic Banking Company Act.

The Islamic Development Bank

Operating since mid-nineteen-seventies, the Islamic Development Bank has 54 member states (by the end of 2002) whose economic development, along with that of the Muslim communities in non-member states, is its objective. Functioning in accordance with Islamic teachings, it has participated directly in developmental projects as well as helped setting up institutions for that purpose. Inter-Islamic cooperation is one of its main concerns. It has also played a significant role in promoting trade between member countries. Technical assistance, providing guarantees to investors in member countries and managing the surplus liquidity of other Islamic banks are also some of its contributions. It has been promoting education in the Muslim communities in non-member countries and has provided humanitarian aid to victims of earthquakes, etc.

Since its inception total financing done by IDB has exceeded 27 billion US dollars, 63.2% of which has gone to finance trade through *murabahah* (IDB, 2001-2002, Table 01 on p.22; Also pp. 33-34). Profit-sharing does not appear as a mode of financing during the last few years (IDB, 2001-2002, Table 01). However, IDB has been doing equity financing of projects at a modest level all these years. Also, IDB has provided interest-free loans to the tune of over 2 billion US dollars in the same period. Only the actual cost of administering these loans is recovered from the borrowers as service charges. Ordinarily they are below 2.5%. (S&P, 2003, p.6)

Islamic Development Bank has helped establish, with substantial amount of equity participation, an Export Finance Scheme (in 1985), the Islamic Banks' Portfolio for Investment and Development (in 1987), an Islamic Corporation for Development of the Private Sector (in 1999), the Awqaf Properties Investment Fund (in 2001) and the World Waqf Foundation (in 2002). One of IDB's important subsidiaries is the Islamic Research and Training Institute, established in 1981.

Among the institutions recently established on IDB initiative is the Islamic Financial Services Board (IFSB), headquartered in Kuala Lumpur. It seeks 'to spearhead the development of a uniform set of prudential, supervisory and disclosure standards for the Islamic services industry internationally.'(http:// www.ifsb.org Press Release, 3 November 2003, welcoming address by the chairman). The standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI),

established in 1990 (AAOIFI, 2002), have already gone a long way in fine-tuning the Islamic financial industry. Soon to emerge from the formation stage is the IIRA, the International Islamic Rating Agency, to be registered in Bahrain. Besides the well-known functions of a rating agency it 'will scrutinize also *shariah* aspects of financial institutions and products' (Ali, 2002, p. 12). Also, a working group is engaged in preparing a blueprint for the establishment of the International Islamic Financial Market (IIFM). 'The objective is the establishment of a more structured global financial market based on the *shariah* principles and to enhance the cooperative framework among Islamic countries and financial institutions' (Ali, 2002, p.13). Already the General Council for Islamic Banks and Financial Institutions (GCIBFI), established in 2001 with its headquarters in Bahrain, is 'working to support the Islamic banking industry…. especially collate accurate information and data on the industry'. (BMA, 2002, p.11)

Islamic Finance and International Finance

The guiding principles of Islamic finance – keeping away from prohibited goods and services, avoiding interest, introducing sharing-based modes and keeping a link with the real sector even while using debt creating modes---have yet to make an impact on international movement of capital. The main reason, it should be admitted, is that the amount of money handled by Islamic financial institutions world-wide is very small when compared with the total amounts at the world level. A more relevant perspective could be of all the ethical investment funds and socially responsible banking put together, along with Islamic finance. Even though avoiding interest may not be a common feature in this larger grouping, what is common - certain positive goals and the desire to exclude harmful industries - is sufficient to justify the linkage. It has the potentiality of persuading large players on the international arena to provide new 'windows' in harmony with the desire of investors who wish never to harm anyone for the sake of making a profit for themselves. That this purpose is best served when interest-based loans are not adopted as a means of international finance can come later or remain confined to the Islamic subset of the larger set of ethical investors. The important thing is to displace profit motive as the sole objective of cross border investment.

Islamic economists have been arguing that short-term interest bearing loans, which soon assume the role of 'hot money' flying around the globe in search of marginal gains in profit, cause much of the kind of trouble the world

witnessed in the late nineteen-nineties. Profit-sharing and commodity related debts by which loans are replaced in Islamic finance offer a better alternative to these loans.

Conclusions

The lesson to be drawn from our discussions in this chapter is that: Absence of interest from the financial scene does not seem to be hampering economic activity. A system of financial intermediation based on profit-sharing and trade related modes is able to replace the conventional interest based system. For savers, a whole range of products, from demand deposits to investment accounts, certificates and funds, with low but almost guaranteed returns, as well as those carrying higher risks and promising larger profits, are available. For credit seekers too there is a variety of options. So, financial intermediation goes on. The question is, how efficiently? It is time to discuss what promises the Islamic financial system bears at the macroeconomic level in terms of stability, efficiency, equity and growth. That is the task we take up in the next chapter.

CHAPTER 4

ECONOMICS OF ISLAMIC FINANCE

Having shown how a modern economy would function after *riba* is abolished, we now proceed to argue that such a state of the economy would be an improvement on the one we have under the conventional system of finance. Among our main criteria for evaluation and comparison will be stability and efficiency. We will also argue that *riba*- free Islamic finance may be more conducive to growth and development. Last but not the least, we will show that human society would gain in justice and fairness, leading to a more equitable distribution of income and wealth, were it to adopt the alternatives to interest-bearing loans discussed in the previous chapter.

This chapter has a crucial significance for the main task of this book, namely presenting the rationale for the prohibition of bank interest, which we have shown in chapter 2 to be covered by *riba*. Though human obligation to obey God is not subject to an understanding of the rationale of divine commands, such an understanding is desirable. It makes compliance easier and helps in applying general principles to particular situations. This is especially true of divine commands relating to worldly affairs, as the *hikmah* (rationale) of divine laws relating to worldly matters (*mu'amalat*) inheres in the benefits they bring to human beings. Also, the better our understanding of the benefits of avoiding interest the more our ability to secure those benefits.

In what follows we examine some of these benefits. We do so, primarily, by examining the alternatives to interest available in the Islamic framework. We shall argue that the adoption of *mudarabah* (profit-sharing) at the liability side of banking institutions in particular and that of the other financial intermediaries in general, would make the financial system relatively more stable than it could be under any other dispensation. We shall also argue that the sharing arrangements between the suppliers of resources and users of resources for producing real wealth reduces the amplitude of business cycles and contributes towards greater stability in the real economy. This will be followed by the complementary argument that the monetary system in an Islamic economy, in which money creation takes place more on the basis of equity generation and less on the basis of debt creation, will be far more stable than a system in which

money is created by extending loans and expanding credit. Lastly we look at exogenous sources of instability like capital movements and international finance and see what difference introduction of profit-sharing would make after interest is abolished.

Relative Stability of Islamic Financial System

Relative stability of the Islamic financial system results from the equivalence and synchronization between the payment obligations of the financial intermediary and its revenue accruals, as obtains in sharing-based modes of finance. We will explain this in the case of simple *mudarabah* contract then proceed to examine the other possible cases.

Take a financial intermediary all whose liabilities are in the form of deposits into investment accounts based on *mudarabah*. Also, all its assets are in the form of money capital supplied to entrepreneurs on the basis of *mudarabah*. The actual amounts of revenue accruing to the financial institution from the entrepreneurs would remain uncertain. But this would cause no problem as its obligation to pay to deposit holders is contingent on what actually accrues to it. It would not face any liquidity shortage.

It would not face any threat of insolvency. There would be no run on the bank due to reports that it is losing on some of its investments. Depositors into investment accounts who withdraw in such a situation would stand to lose, as they must bear the losses accruing to the bank. Depositors who wait till the worst is over may hope to recover some of the losses through improvements in the pool's performance.

As regards the time profile of the obligations to pay, it will require good management to function in a problem-free manner. Let us take the simple case of an intermediary who has only one deposit on the liability side and who is dealing with a single entrepreneur on the asset side. Good management requires it to synchronize the timing of revenue accrual from the entrepreneur with the contractual time of repayment to the depositor. There is no reason for it to do otherwise.

Multiplicity of account holders and entrepreneurs does not alter the situation basically. The payment obligations of the financial intermediary still remain equal to the (uncertain) amounts of actual accruals. But the task of

synchronizing accruals and payments will become more complicated insofar as their timings are concerned. It will require careful planning in terms of diversification of investments on the assets side and making small pools of deposits on the liability side, keeping in view their respective time horizons. Successful management in this regard is likely to become a basis for competition in good performance. Even after taking these steps at the individual firms' level, prudence requires some extra measures at the industry level to meet unexpected situations. The literature on this subject discusses some of these measures. One such measure is keeping a small fractional reserve against the (investment) deposits. The other is provision for inter-bank flow of short-term liquidity and central bank assistance in time of need, a kind of lender of last resort arrangement. Dealing with the differences between the maturity structures on the asset and liability sides would be the same as in conventional banking. But, in conventional banking the assets are predominantly interest-bearing debt whereas in Islamic banking a large percentage of assets would be real assets representing either equity (stock) or quasi equity (profit-sharing). Islamic banking assets would, therefore, be more diverse in kind, adding a measure of lower risk to their balance sheet.

Introducing *Musharakah*-based assets would not fundamentally change the situation, even though it may increase the risks for the bank. Financial intermediaries now advance money capital to entrepreneurs in whose enterprise they are active partners. Their representatives sit on the boards of these firms taking part in strategic decision-making. They share the risks as well as the gains. They share profits of the enterprise with their partners in agreed ratios and bear losses in the ratio of their respective capitals. As their exposure to risk increases, financial intermediaries using *musharakah* will be obliged to diversify further, as one of the many ways of risk management.

Let us now introduce some non-sharing modes of finance. The assets side may now have claims to rents (on leases made), amounts receivable (on installment sales on *murabahah*/*bay'mu'ajjal* basis). Obviously this is not going to affect the correspondence of actual revenue accruals with payment obligations of the financial intermediary as long as its liabilities retain their original nature of *mudarabah* deposits. However it introduces a new element in the environment hitherto absent: the possibility of unavoidable default by the entrepreneurs (i.e. those 'financed' on the basis of *ijarah*, *murabahah* or *bay'mu'ajjal*).

In *mudarabah* the working party's obligation to pay back to the financier equals capital plus profits minus the entrepreneur's share out of the profits. In case there are no profits, the entrepreneur's share is zero and the financier gets back the capital net of losses. Non-payment of that amount would amount to outright theft which the legal machinery is there to take care of. But when the entrepreneur's productive project has inputs obtained on the basis of credit purchase (financed by the intermediary on *murabahah* basis), collapse of that project will not affect the entrepreneur's obligation to pay back the stipulated price to the financial institution. Default may result, despite the good intentions of the entrepreneur, because of inability to make full payment out of what remains of the project.

Insofar as the timings were in sync before the occurrence of default, it would cause no problem for the financial intermediary on that account. The inclusion of assets based on leasing or *murabahah* financing will not change the environment for the financial intermediary as long as its liabilities are *mudarabah* based. But the possibility (and, later on, the occurrence) of default will pose other problems not present in the aforementioned environment in which all assets were *mudarabah* based. To these we return later. We conclude that the distinguishing feature of Islamic finance that it effects a synchronization between the revenue accruals of the financial intermediary and its payment obligations remain unaffected by any changes on the assets side as that feature depends on the liabilities being based on *mudarabah*.

Onwards our discussion has two different paths to follow. First we trace the implication of this characteristic for the stability of the financial system. Next we examine possible changes on the liability side and their consequences.

Absorption of Real Shocks

An important source of instability in the economic system is changes or perceived changes in the real economy causing profit expectations (and/or accruals) to be revised upwards or downwards. These are likely to cause redrawing of investment plans impacting demand in several markets. That is what we call real shocks to the economy. As is well-known they could trigger a cyclical movement in economic activity – in price level (inflation rate), employment and output.

There are a number of ways in which the process may be triggered. In an environment of rising expectations regarding profits, entrepreneurs would tend to expand investment. The demand for finance will increase if its 'cost' remains the same or fails to rise to the same extent to which expected profits have risen. In an economy in which finance comes on the basis of profit-sharing the cost per unit of capital will move in the same direction as the profits as it is calculated *post facto* as an agreed ratio of the profits. We can, therefore, 'conclude that under the Islamic financial system the amplitude of all phases of the cycle will be smaller'. (Chishti, 1985, p.9)

Another factor that fuels the trigger mechanism is speculation. When profit prospects are rosy and it is possible to finance positions in capital and financial assets by borrowing, enterprises as well as financial institutions tend to speculate on future cash flows and market conditions. The result is the familiar Ponzi finance (www.sec.gov/answers/ponzi.htm). But such speculation makes little sense when the investible funds can be acquired only on terms of sharing the actual outcomes.

The property of the Islamic financial system studied above makes it absorb real shocks to the economy in the form of changes in the prospects for profits (i.e. business expectations regarding profits). Increased profitability, actual or expected, automatically raises the 'cost of capital' whereas an expectation of falling profits, or an actual fall in profits, automatically reduces the cost per unit of capital. In other words, basing the supply of investable funds to business enterprise on profit sharing serves as a counter-cyclical device by making the cost per unit of capital move in the same direction as the expected profits. This tendency is reinforced by changes in the ratios in which business enterprises have to share their profits with the financiers (i.e. the financial intermediaries). [Siddiqi, 1983 b, pp. 111-112]

When finance is done through trading future money for present money, there is an integrated debt market in which debt instruments are traded at will. In such markets speculation on interest-rate expectation would be rampant. As seen in current debt markets, speculative transactions are manifolds of real transactions (transactions for production or commodity trade purpose). This set-up becomes a source of both instability and contagion. In economies where finance is done through equity, profit-sharing or commodity-finance methods, there is no integrated debt market so speculation will move around profits as well as commodity demand and supply expectations. Such expectations would

be dominated by fundamentals rather than by traders' moods. Instability will be, therefore, narrower and less often. In addition, as debt will not be readily marketable, 'hot money' would not become a source of contagion.

Stability in the Monetary Sector

Another important factor in making an Islamic economy relatively more stable would be the way its money is created and managed. As interest is abolished and largely replaced by sharing modes of finance, money creation too will largely take place through the application of sharing modes of finance. Most of the capital supplied to business would be on the basis of sharing the profits resulting from its use. Insofar as part of these monies find their way as deposits in the banking system (Siddiqi, 1983 a, pp. 73-96) the money supply would have increased. This trend in the private sector would be reinforced by the central bank using sharing based modes of finance to create high powered money, inject liquidity in the system when needed and extend necessary finance to the government.

Exogenous Sources of Instability

At the international level the chief source of instability in the financial system has been the movement of 'hot money'. Billions of dollars entrusted by their owners to institutional investors – mutual funds, pension funds and insurance companies---as well as investment companies and commercial banks, move across borders chasing higher profits than available at home. Most of these come as short-term loans in the form of high quality bonds or as equity (stocks) purchased in the stock market. There is no long-term commitment on part of these financiers. A slight differential in profit margins makes them move funds in or out. This causes grave problems, especially for small developing economies.

In our simple model without debt finance, foreign capital too would be admitted only as equity. This would make the outflow of capital equal to the inflow plus the profit-share due to it or minus the losses it suffered, as the case may be. That will cause some trouble at the microeconomic level without seriously disturbing the economy at the macroeconomic level. That leaves only the possibility of the timing of outflow threatening the stability of the system. The prospects for the host country would still be better compared to the loan capital scenario as, "equity participation more often than not entails longer-term

commitments that cannot be undone in response to minor or transient changes in rates of profit". (Zarqa, 1983a, p. 185)

Relative Stability with Fixed Liabilities

On the liability side let the Islamic financial intermediary accept deposits payable on demand. These are in the nature of loans to the bank/financial-intermediary. But the bank/intermediary pays no interest and the depositors into these accounts receive no return. Only, their principals are guaranteed and they enjoy checking facilities. This being the case, the supply of these deposits into the banking system cannot be influenced by anything that banks could do, unlike the supply of investment deposits that responds to the returns they bring to the depositors. These returns in turn partly depend on the ratio in which the banks/intermediaries share their profits with the depositors (Siddiqi, 1983 b, pp. 103-04). As regards the supply of demand deposits it depends on such long-term factors as the banking habits of the public and the level of their income. It is sensitive to the banks' ratio of profit-sharing with investment depositors only indirectly. A rise in that ratio may cause some transfer of funds from demand deposits into investment accounts and vice versa. For the sake of simplicity we shall ignore this effect as it does not affect our main presumption: that the supply of investment deposits is positively related to the ratio in which banks share their profits with the depositors into investment accounts (as this ratio determines the rate of return on deposits, given the rate of profits on investment).

Insofar as the banks operate on a fractional reserve system and are allowed to use part of the demand deposits for profitable investment, introduction of demand deposits introduces a potential source of instability. The fixed payment obligations created by these deposits have to be matched by modes of investment, which guarantee the principal, for the bank always to stay solvent. Modes of investment based on *murabahah*, *ijarah*, *salam* or *istisna*' provide this kind of investment opportunity, as we have seen in the previous chapter. These create assets, which guarantee the principal and promise to bring in predetermined returns. However they create debts that carry the possibility of (unavoidable) default, as we have seen above.

Keeping this in mind we now recall the properties of the simple model studied above and see what modifications are called for after the introduction of fixed liabilities. Obviously the equivalence between revenue accruals and

payment obligations no longer holds, nor does the perfect synchronization between revenue accruals and payment obligations. It now requires special measures on part of the regulators, special skills on part of the managers, etc. to synchronize, whereas it was automatic in our simple model. It needs being noted, however, that the ability of Islamic banks to accept specific investment deposits with flexible time profiles but specified areas of investment, etc., will enhance their capacity to solve the synchronization problem. Also their ability to sell investment deposit certificates which can go on changing hands in the market without the banks being called upon to pay cash against them before their maturity, makes it easier to meet payment obligations on time.

The capacity of the system to absorb real shocks to the economy remains, however, unaffected by the change, to a great extent. Should the profit expectations of businessmen rise, raising the demand for invest-able funds, the financial intermediaries can meet the demand only by persuading the general public to save more and deposit their savings with them. To a small extent they can also persuade account holders to transfer part of their demand deposits to their investment accounts. An increase in expected profits is likely to bring more funds into the investment accounts, yet the banks may have to raise the ratio of profits given to depositors to ensure greater supply of funds. They may, therefore, also demand for themselves a higher proportion of the profits realized by their business partners. This raises the 'cost of capital' for entrepreneurs. The reverse would happen in a downturn when the demand for investable funds is going down due to downward revision of profit expectations. The cost per unit of capital for entrepreneurs will tend downwards. This is the same as in our simple model with no fixed liabilities. The capacity of the Islamic financial system to absorb real shocks remains, maybe slightly diminished, despite the introduction of demand deposits.

Demand deposits against which checks can be drawn are part of the money supply, M1, along with coins and currency notes. So their introduction affects the results of our model through the monetary sector.

Also, on the assets side the existence of debts (generated by such modes of finance as *murabahah* and leasing) creates the possibility of some debt instruments being used as money substitutes. Most scholars think these debts cannot be traded. They can only be transferred at par, at their face value (Usmani, 2000). However there are some scholars who allow trading in debts in an Islamic financial system (Securities Commision, 2002, pp.16-19). But the

fact that in an Islamic financial system debts are created as a result of commodity transactions and not by lending money has important implications for debt 'market' in such an economy. Whether such debts are used to repay other debts or to purchase commodities, the transaction costs will be very high due to the need of assessing the quality of each debt. In the case of using debt for purchasing real goods and services, the need for ascertaining debt quality would be even higher as the seller of commodities must be assured of getting the payment. Debt can at best be a rather inferior substitute for money in an Islamic economy.

To the extent the money supply in an Islamic financial system comprises demand deposits and some inferior money substitutes, the direct linkage between money supply and production possibilities will have become weaker. Monetary policy will have to make sure that the money supply, consisting of expansion in the form of profit-sharing finances as well as demand deposits and some debt instruments, is kept in harmony with the changing level of national income to avoid inflation or deflation.

It is worth reiterating at this stage that the debt instruments generated by modes of finance such as *murabahah* and leasing still have a direct link with the production possibilities. The difference arises in case of failure of a production plan to create additional wealth (i.e. an output in terms of value larger than the inputs). In such a case the money paid back by the entrepreneurs to the financier in case of profit-sharing would equal what remains of real value in the failed project, whereas the money paid back to financiers in case of *murabahah*, leasing, etc would be what was provided for in the original contract, unaffected by the failure of the project. This difference in the way debts are created in the two systems, the current conventional one and the Islamic, interest-free one being visualized and described by us, as well as between the way the debt market functions in the two, has far reaching consequences. (Al-Jarhi, 2002, pp.11-13)

In order totally to remove the financial system's vulnerability to instability because of allowing the banks to use part of the demand deposits in their profit-making activities, a system of keeping 100% reserves against demand deposits has been suggested (Al-Jarhi, 1983, pp 74-75). It has also been noted that doing so is more harmonious with Islam's approach to property rights. (Mirakhor, 1995, p.37)

In the absence of empirical evidence till date, it can only be surmised that the larger the ratio of demand deposits on the liabilities side and the more the ratio of debt finance (based on debt-generating modes like *murabahah* and leasing) the more the vulnerability of the system to liquidity problems and threats of bankruptcy.

To recapitulate, relative stability of the Islamic financial system is claimed, theoretically, on five grounds:

- Equivalence of payment obligations with revenue accruals;
- Synchronization between revenue accruals and payment obligations;
- Capability to absorb real shocks to the economy through appropriate changes in the cost of capital;
- Supply of new money being directly related to the possibilities of creating new wealth;
- Admission of foreign direct investment on profit-sharing basis.

As we have seen above, when these properties hold as in our simple model in which all assets and liabilities are based on sharing modes of finance, we have a relatively stable economy even when debts are introduced on the assets side but liabilities remain based on sharing. But the system starts losing some of its pro-stability features with the introduction of debts on the assets as well as the liabilities side. Even then, it remains closer to production possibilities in the real sector and far away from the type of wild fluctuations we observe in an economy in which both money creation and investment is based on debt.

Limited Scope of Speculation in an Islamic Financial System

An important source of instability in any financial system is speculation. Speculation inheres in estimating future values of key variables such as prices, profits, costs, imports, export demands, employment, etc. Speculation may also relate to noneconomic events that are likely to affect key economic variables, such as change of governments, wars, etc. Speculation is important because it affects current economic behaviours causing changes in demand and supply of goods and services, investments, etc. Speculation is part of the 'ordinary business of life' that is economics as economic activities are time taking activities. They necessarily involve the future. Trade is especially speculative as

it flourishes by buying cheap and selling dear, which involves estimating future prices and demands.

It is not the above kind of speculation that poses a threat to stability, because the type of instability it may cause is taken care of by economic forces, as shown by economic analysis. Speculation that is a threat to stability, especially financial stability, is that focusing not on economic variables but on how other peoples may be estimating those variables or on the occurrence of noneconomic events such as natural calamities, wars, revolutions, change of government, etc. Further down that road, some try to make others speculate in a certain way by misinformation, spreading rumors, giving false accounts, etc. in order to exploit the profit opportunities created by behaviour induced in this manner. If we consider gambling to inhere in creating risks with the intention to profit by taking the risks so created, it is gambling like speculation that is a threat to stability. Gambling-like speculation is in the nature of a bet on occurrences not connected with the economic activity of the one who is betting. Most of such speculation in contemporary financial markets relates to debt instruments and to movements in the rate of interest. In an interest-free Islamic economy where all debts are based on purchase of real goods and services and the rate of interest is absent, there will be no scope for gambling-like speculation. One cannot envisage the ratio of profit-sharing becoming an object of such speculation for several reasons. First, it is, normally, not a policy-determined variable but a market determined one. Secondly, it is not a unilaterally imposable measure but a result of agreement between the parties involved. Lastly, it is expected to move in the same direction as the expected rate of profit. As a result, speculating about the ratio of profit-sharing is as good as speculating about the rate of profit itself, the stuff of all trade.

It can be argued that debt financing spurs investors to speculate whereas profit-sharing finance creates no such pressure. Debt financing of productive projects creates a pressure to speculate in two distinct ways. Firstly, productive projects usually take longer periods of time to complete than the time for which loans are available. This makes the financial intermediary give a medium-term loan even though it has only short-term deposits. In doing so it is speculating as to the chances of getting new short-term deposits in the future. In a similar manner, an entrepreneur may decide to finance a long-term project by a series of short and medium-term loans. He/she is speculating as to the availability and cost of the new loans in future.

This does not happen in profit-sharing finance in which the financial intermediary has funds deposited into the investment accounts it is holding with the mandate to invest long term (actually an spectrum of such mandates differing in size and time horizon). The same applies to the entrepreneurs insofar as he/she is willing to obtain funds on profit-sharing rather than be financed with debt generating modes like *murabahah* or leasing. Even in the latter case there is a greater possibility of aligning repayment obligations with expected revenue accruals than in pure debt finance (in which you borrow a sum of money).

It is in the nature of speculation to fuel instability as well as be fuelled by instability. In a perfectly stable economy (J. S. Mill's stationary economy) in which future values of economic variables are known to be the same as the current values, there would be no speculation. But such an economy does not exist. Instability increases the hiatus between current values and (expected) future values of economic variables by increasing the uncertainties involved. The more instability there is the larger that hiatus and the more the incentive for speculation (as the possibility of making a large gain is always more tempting than the possibility of making a smaller gain even when the risk of loss moves in tandem). The vicious circle of speculation causing instability in the financial sector that may then spread to the real sector that in turn gives a fillip to speculation is often the stuff of economic crises.

In the light of the above we add a sixth ground for expecting relatively less instability in an Islamic financial system with a strong role for profit-sharing: a smaller scope for speculation. (Also see, Mirakhor, 1995, pp. 42-43)

Relative Efficiency of an Islamic Financial System

Efficiency lies in producing more with less. Allocative efficiency, which is in focus in this discussion, lies in allocating society's resources so that the total product is maximized. That holds when the marginal productivity of investment is equal in all industries throughout the economy. The upshot of this rather ideal scenario is that capital should be invested where its productivity is the highest. We measure value productivity in terms of expected profitability, ignoring the information issues involved. Capital should, therefore, be allocated on the basis of expected profitability.

If all the capital that is invested in production was owned by those investing it, the desired result as stated above would hold, given the usual assumptions relating to information, rationality and competition. When all the profits of the enterprise accrue to the owner-financier, and in case of loss he or she bears the entire burden, we can expect resources to be employed in accordance with expected profitability. But the situation changes when those who produce have to obtain money capital as loans from others. The financier is concerned with the safe return of capital as well as with the interest contracted for. That is best ensured when the borrower already has enough resources to meet its payment obligations and is not dependent on the success of the project, which is being loan-financed. This gives creditworthiness of the borrower-entrepreneur first place in the consideration of the financier. Prospects of the entrepreneur making profits remain very important though. In fact the financier would hardly venture to lend without such prospects. Nevertheless they are relegated to the second place. This shows itself more when we compare possible attitudes toward different projects seeking finance. …. 'let us imagine the existence, at a particular time, of a large number of entrepreneurial projects all of which carry an expected rate of profit higher than the market rate of interest, both in the assessment of the entrepreneur as well as the financier. Assume for the sake of simplicity that the degree of uncertainty associated with each expectation is the same. These projects can then be arranged according to the expected rate of profit they promise, in a descending order. Secondly the same projects can be arranged in a descending order according to the creditworthiness of the entrepreneurs presenting them. It is plain to see that a project may not occupy the same position in the two orderings. Society's interests are best served when projects are financed according to the first ordering, the one based on profitability. But the flow of finance on the basis of contractually fixed interest payments largely follows the second ordering based on the creditworthiness of the borrowers. This involves a departure from optimum allocation of resources. In an interest-based system expected profitability ceases to be effective in ensuring an efficient allocation of investable funds because of the terms on which these funds are supplied - loans carrying interest'. (Siddiqi, 1983b, p. 70)

The entrepreneur's attitude towards the project is also affected adversely in case of debt financing. The contractual obligation to repay the capital with interest added thwarts the entrepreneur from experimentation and innovation in the quest for higher profits. The refusal of the financier to share the

uncertainties involved deprives the society of possible gains in the productivity of capital through innovation.

A system in which finances flow to the entrepreneur on the basis of profit-sharing largely retains the features of the owner-financier model noted above. In a two tier *mudarabah* scenario in which financial intermediaries are advancing capital to entrepreneurs on the basis of sharing their actual profits, having promised the same to the depositors in their investment accounts, the total supply of money capital tends to be allocated into uses promising highest profits. The introduction of demand deposits on the liability side and debt-creating Islamic modes of financing like *murabahah* and *ijarah* on the assets side does not basically alter this conclusion. It only tends to dilute it insofar as debt-creating finances go to the creditworthy parties and the expected profitability of the projects being financed becomes a secondary consideration. The Islamic modes of financing that result in debt creation still keeps financing tied to the real sector production plans. *Murabahah*, *ijarah*, *salam* or *istisna*' all share the characteristic that there are real goods and services matching the finance originally offered. These real goods and services made part of a productive enterprise from which the entrepreneur did expect to make enough money to be able to payback the (higher than the spot) prices of what he/she got through *murabahah* financing or its debt creating alternatives. Where these modes depart from the sharing modes is that the entrepreneurs' obligations to pay back are frozen at the level specified in the contract. They are not related to the actual profitability of projects as is the case in profit-sharing. This has implications for money supply as well as for the other properties of the Islamic financial system, like synchronization and equivalence between payment obligations and revenue accruals. But it does not rupture the tie-up between Islamic finance and the production sector. Only, to the extent debt financing replaces profit-sharing, creditworthiness of the parties being financed takes precedence over profitability considerations.

The problem with interest bearing loans is, however, different from the problem of financing on a deferred payment basis as in *murabahah*. A money loan with guaranteed repayment has no link to the real economy. In an environment in which no value creation takes place outside the market (as value is a market phenomenon and not an intrinsic property of things, anything) the institution of interest grants added value to a loan even before it enters the market. On the contrary, *murabahah*–financing does involve the market. The added value claimed in this case---the excess over cash price of the commodity

supplied on deferred payment---is attached to a real good intended to serve as input in a project the output of which the entrepreneur expects to be larger than input. The two additions, the one of interest to a money loan and the other of excess over cash price in *murabahah*, are different both in their origin and in their economic consequences. Money capital is not an input in any productive process whereas goods are. It is important to note, in the context of efficient allocation of resources, that the Islamic modes of financing, including those based on deferred payment, are nearer to the ideal scenario of owner financing. Interest-based financing is far removed from that ideal.

Uncertainty and Efficiency

One of the important arguments in the quest for greater efficiency has been the way uncertainties attending upon productive enterprises are faced. Two things are involved, incentives and methods of facing uncertainties. Why should one face uncertainty? And what ways of meeting it should one select out of the methods available at a particular time?

Before we take up the above questions, let us have a look at the relation between uncertainty and efficiency. Life in general and our economic life in particular involve changes that accompany the passage of time. Our tomorrows are not a repetition of the present just as the present itself was not a replay of yesterday. Most of our actions, in particular almost all production of goods and services, take time. We begin doing something now knowing it will be completed in the future. This necessitates predicting what the future will be like, especially in what ways it may be different from the present. These are not idle guesses. Much is at stake on their being correct or incorrect. A producer is proceeding on the expectation that a certain price for the product will rule in the market sometime in the future. His/her gain or loss would depend on the correctness or otherwise of that estimate. A loss would mean losing what one already had, which is so bad no one would like it unless there is a reason. But there is no way of being one hundred per cent certain, such is the nature of our environment.

The incentive to court a possibility of loss lies in the possibility of gain. Except for those who work for others, making money generally involves taking some risk. Economists call this act of facing uncertainty with a view to making money an act of entrepreneurship. It lies at the heart of progress.

The entrepreneur would naturally exert all his/her ability to make the project a success given the fact that the gains will be all his/her. But the incentive issue becomes complex when we move from the simplest case of owner-entrepreneur investing personal resources to other cases. Let us assume the entrepreneur's project is financed by money capital acquired from others. In that case the crucial thing is the terms on which financing has taken place. Let us take the case of *mudarabah*. In profit-sharing there is an asymmetry in the effect on entrepreneurial motivation in case of possibility of gains and that of making a loss. Whereas the entrepreneur is expected to behave as if investing own resources insofar as he/she is in the profit-making zone (being a sharer in every additional dollar earned), the exertion level may start slipping downwards as the project enters the loss-making zone. There is still an incentive for avoiding losses as the reputation of the entrepreneur and the chances of getting finance in future would be at stake. But the fact that in profit-sharing, losses are borne by the owner of capital may weaken the incentive to do whatever possible to minimize losses.

Compare the two simple cases of borrowing on interest and profit-sharing (*mudarabah*). Borrowing transfers the ownership of funds to the borrower. The gains of enterprise will belong to the entrepreneur after paying interest, along with repayment of the capital to the lender. The entrepreneur will be in bad shape in case of loss as the sum borrowed will still be due to the lender along with the interest. This may permanently damage the chances of the entrepreneur's continuation in business. In fact his/her 'losses' start as soon as the realized rate of profit dips below the rate of interest. On the one hand his/her past savings are consumed in meeting current payment obligations and on the other hand his/her reputation suffers too, making it difficult as well as more costly to get finance in future. As compared to this, the one who obtained equity finance fares far better, as past savings are not involved in meeting current payment obligations. The borrower-entrepreneur may, however, fare better than the equity-financed one in case the realized rates of profit are very high.

A simple example will clarify what we mean. Should a project make 20% gross profit, given the rate of interest to be 10% and equal sharing of profit between entrepreneur and financier, the entrepreneur ends up with the same income whether he/she borrows or enters into a profit-sharing contract. It is only when gross profits are higher than 20% that the borrower fares better. But very large disparity between the rate of interest and the rate of profit multiplied

by the rate of profit-sharing should not be a very common occurrence insofar as the rate of interest must follow the trend of the rate of profit in an economy.

It follows that acquiring finance on profit-sharing is nearer to the ideal scenario of self-financing, insofar as incentive to work and exert ones best is concerned.

Meeting Uncertainty

The distinctive feature of profit-sharing financing as compared to debt financing is a distribution of uncertainty of profit between business and finance. That definitely is an advantage for business. It should make it take up projects hitherto considered beyond its range in view of its resource position. It can also take greater risks and court more uncertainty because part of the consequences will be borne by the financier. Both features, more productive projects being undertaken and more risks being taken, should increase the efficiency of the system. There are no universal rules when it comes to how best to face uncertainty. Each situation is unique and requires finesse even in applying well recognized rules.

Profit-sharing involves the financier into the entrepreneurial function. The financier would like to share risk management with the user of the funds it is providing, as its own interests are deeply involved. This can be done in a number of ways. Both current practice and Islamic rules relating to participatory finance provide a wide room for that. The details should not detain us here. What matters is the comparative advantage of this arrangement over debt finance insofar as efficiency is concerned.

It is obvious that the financier can be a risk-taker and uncertainty-bearer only to the extent it is authorized to do so by the owners of capital - the depositors into investment accounts in case of Islamic banks. As we have seen in the previous chapter, Islamic banks already have a variety of investment accounts. Further diversification according to degrees of exposure to risk is not ruled out.

The savers in an interest-free Islamic economy will thus be presented with a whole spectrum of kinds of deposits. Demand deposits, with guaranteed return of capital on demand but bringing no returns to the depositor, form one end of this spectrum. The other end is provided with general investment

accounts with no conditions attached, investment strategy being put entirely at the discretion of the bank. In between we have accounts whose funds are to be invested only in the leasing business, for example, or for extending credit on *murabahah* basis, and so on. This wide range of products should be able to match the preferences of various kinds of savers insofar as their risk profiles are concerned. That should ensure mobilization of all available surpluses in the economy, meeting one of the primary conditions of efficiency. (Allais, 1968, p.17)

This tripartite arrangement, involving wealth owners, financial intermediaries and investors aligns the interests of all three parties by making each share the risks and uncertainties involved in realizing the goal of earning profits to the extent each desires. At the same time it does not force anyone to take risks one does not want to take, provided one also gives up the desire to earn profits attached to those risks. It does offer almost risk-free avenues of employing one's savings profitably, as in case of leasing or *murabahah* based Islamic financial products. But the rates of return are usually smaller and there still remains the risk of default.

The 'alignment of interests' to which we have alluded in the previous paragraph can be better appreciated when seen in contrast with the case in interest-based financing. 'It may be recalled that saving in traditional markets is positively related to the rate of interest on deposits, but investment is negatively related to it. Therefore, an intermediary that raises the interest rate to mobilize more resources from savers may find it difficult to market these resources to investors. This 'inconsistency of purpose' hardly exists in an Islamic framework'. (Al-Jarhi, 1998, p. 195)

Financial intermediaries play a key role in mobilizing investable resources and, as we have seen, the above-mentioned tripartite arrangement affords them a far greater flexibility and scope for maneuver than the interest-based alternative currently in vogue. In the conventional framework the degrees of freedom for the intermediary are limited to the spread between the two rates, the rate of interest charged to the borrower and the one paid to the depositor. In the Islamic framework the intermediary may contract with the investor (the fund user) for a share in the actually realized profits ranging between 1% and 99%. Similarly on the other end, the intermediary may offer the depositor a share of profits ranging 1% to 99%. Translated into a percentage rate per unit of capital the 'spread' in case of a profit-sharing intermediary would always work out to

be lager than in the conventional case in similar profitability environments. (Also, see Al-Jarhi, 1998, p. 195 and p.208, fn. 9)

Comparative Advantage

We conclude that an arrangement based on profit-sharing, with some room for debt creating transactions like *murabahah*, is more efficient than the one based entirely on debt finance in which all the risk and uncertainty is shifted to the entrepreneur. The reason is, debt-finance does not have any obvious advantage over the profit-sharing alternative insofar as mobilizing surpluses is concerned. It is in fact disadvantaged by the limited scope for maneuverability, and has a definite disadvantage insofar as the investor is held back from taking greater risks and launching more productive projects due to own-resource constraints. As we have argued above, the investor in the sharing environment tends to take greater risks and expand projects more in view of the consequences being shared by the financiers and, through them, by savers. Similar conclusions have been reached by more sophisticated studies made earlier. (Mills and Pressley, 1999, pp. 35-37)

It has been rightly argued that the transaction costs in an interest-free Islamic system will be lower than they are in the conventional system, the reason lying in greater integration of the financial sector with the real sector in the former system (Al-Jarhi, 2002a). Lower transaction costs enhance efficiency and release resources to be used elsewhere, thus contributing to growth.

Fairness of the Islamic Financial System

We have argued in the second chapter above how *riba*/bank interest constitutes an unfair arrangement for financing business. At the lender-borrower level this arrangement neither ensures equality nor reciprocity, insofar as the benefits exchanged are concerned. In this chapter we are more concerned with the comparison of the interest-free financial system with the interest-based system at the macroeconomic level with respect to justice and equity.

We shall argue that the institution of interest causes inequality in the distribution of income and wealth to increase over time. This is an inalienable feature of the contemporary interest-based system that even the interventions by the state have not been able to undo. We submit that increasing inequality is not just as it cannot be justified on the ground of differences in natural endowments

or work efforts---the bases on which inequality itself is justified. We also submit that while some degree of inequality is found to be morally acceptable in the light of the gains to society in terms of efficiency and growth, a continuous increase in inequality is unacceptable in view of its unbalancing effects on social and political relations within and between nations.

The inequity of interest lies in the refusal by capital owners to share the uncertainties in the human environment with those who share the environment with them. The human situation mandates such sharing.

To elaborate, interest causes a continuous flow of economic resources from the loss-making entrepreneurs to the financiers. The interest paid to financiers as well as the lost part of the principal replaced for them comes out of the resources owned by the entrepreneurs independently of the project financed. This happens in case of productive ventures that failed to create additional wealth. As regards the ventures that do succeed in creating additional value, the financier gets back the principal plus part of the value added, leaving the remaining for the entrepreneur. The sum of all such profits remaining with the successful entrepreneurs may or may not exceed the sum of what the unsuccessful entrepreneurs paid as replacement of lost capital and interest to the financiers. The net position of entrepreneurs as a whole is not known with certainty. What is certain, however, is that the net position of the financiers must improve. This implies a dig into the resources owned earlier by the borrower-entrepreneurs when and to the extent their net position is negative. In the long-run there are bound to be such periods in which a net transfer takes place from already existing wealth of the entrepreneur-borrowers to the lenders. Wealth is made always to bring more wealth. The additional wealth flowing to the creditors from loss- incurring enterprises implies a redistribution of existing wealth of the society in favour of the owners of money capital. Given this built-in inequity, thanks to the institution of interest, the distribution of income and wealth becomes more and more inequitable as time passes. It causes increasing inequality over time as compared to a system in which the financiers' wealth increases only when their financing creates new wealth.

This is what has been happening since interest became the kingpin of the capitalist system of money, banking and finance, roughly over the last four centuries. While absolute poverty declined and the lot of the poor improved, relative poverty increased and the gap between the rich and the poor widened,

both within nations and between nations. (UNDP, 2001, pp. 16-17, 19; UNDP, 2003, p. 39; Wade, 2001, pp. 72-74)

Sharing Enhances Equity

A sharing arrangement between entrepreneurs and their financiers rules out any net transfer of existing wealth from the former to the latter. Any addition to financiers' wealth would, in a sharing arrangement, come out of the new wealth created as a result of the productive employment of their capital by the entrepreneurs. In view of the inequality that already exists, the minimum the society must do to prevent further worsening of the situation is to stop net transfers of existing wealth from the less privileged to the top echelons of wealth-owners, leaving the door open for them to appropriate newly created wealth. Replacement of interest by profit-sharing will be a step in that direction insofar as a majority of entrepreneurs belong to the category of the less privileged.

At the macroeconomic level equity calls for a society without deprivation in which basic needs and human rights are assured for all. The problem is, the institution of interest fosters an approach to economic activity that subverts this possibility. It cannot be said that profit is equally to blame because profit-seeker lays claim only to the value added, the new wealth created by his/her activity. Profit does not dig into the past wealth of anyone. Given some charitable giving on part of the profit-makers, the society can still achieve equity. But the role of interest in this connection is negative. By continuously digging into the past wealth of the society as shown above, interest is continuously disadvantaging those without capital to lend. That disadvantage shows itself in all walks of life. But its implications for power and its distribution among individuals, groups and nations have been especially negative for equity.

The financial system based on interest produces a debt-ridden society. It finances the consumers, the businesses and the government, including the local (city) institutions by creating debts. There is a built-in tendency in these debts to grow over time. This has social, psychological and political consequences that have to be taken into consideration in a discussion of equity. In the ultimate, equity is a precondition for human dignity, a concept we have dealt with in the first chapter and which is only partly covered by the concept of human rights. We submit that debt is demeaning. A society of debtors not only is bound to experience widespread anxiety, most of its members are bound to feel

humiliated and belittled by a system that lures them into the debt trap but does not help them come out of it. This would not occur if financing was largely sharing-based, resorting to debt-creating modes only where sharing was not tenable.

There is a fundamental difference between sharing relations and debt relations. Sharing implies a kind of equality between sharers even when the shares are quantitatively unequal. But the creditor-debtor or lender-borrower relation gives an edge to the former. The edge is there in the law of the land as well as in informal social institutions. Sharing is dignified. An equitable society would, therefore, prefer sharing-based financial arrangements as far as possible. We do acknowledge, however, that in many cases sharing does not work and one has to resort to debt-based financial arrangements - a point we already covered in the third chapter. The important point is that by legitimizing interest a society effectively puts sharing arrangements at a disadvantage. Therein lies its inequity.

If we now turn our attention to the international financial relations we find that the inequity of interest shows itself with a greater force in that arena. Two obvious reasons for this can immediately be noted. First, within a nation state the community, and representing it, the state, still feels some responsibility to redress iniquitous consequences of the working of the system. But no corresponding institution exists at the international level. As a result, a country devastated by the shenanigans of the international financial system has no rescuer, as happened in South-East Asia in 1997-1999. It is not possible in this study to dwell on the relationship between the situation of the poorest countries in Asia and Africa and the functioning of the international financial markets. It needs emphasizing, however, that the predominance of debt over equity in international financial relations is a great deal to blame.

Growth with Islamic Finance

Growth depends primarily on the human factor, the quality of the population, their level of knowledge and skill, etc. But other factors also count. Among one of the most crucial factors for growth and development is a sound financial system. Not only is it needed to mobilize resources and channel them into productive investments, its efficiency and fairness are crucial for sustaining the process of growth itself. An Islamic financial system built largely around sharing modes of finance creates an environment conducive to growth and

development. It does so by aligning the interests of the savers, financial intermediaries and the entrepreneurs. Insofar as growth inheres in creation of additional wealth, the Islamic financial arrangement makes all three share growth. That makes everyone interested in growth, providing incentives to save, invest and work. By abolishing interest it sees to it that no one gets a share out of the newly created wealth without having been a part of the team who worked for it and/or shared the risks involved in working for it.

Islamic economists have convincingly argued against the suggestion of any adverse effects of a switch over to Islamic finance on savings (Siddiqi, 1983a, pp. 167-71; Khan and Mirakhor, 1987, pp. 125-39; Mirakhor, 1995, pp. 43-45). Insofar as the possibility of earning motivates saving, alternatives to interest would be available. Insofar as savings are a function of income, savings may actually increase due to improvement in employment likely to result from a switch over to Islamic finance.

Given the level of productivity, growth is promoted by full employment. A sharing based system of finance has the flexibility to mobilize resources for all projects with a positive prospective productivity. It is far more conducive to full employment of resources including labour than a system that sets a positive rate of interest as the threshold so that projects with prospective productivity below that level are rejected. There is no financing for a project in which the marginal efficiency of capital is lower than the market rate of interest. The problem is further complicated by the fact that the going rate of interest is more often than not a policy determined variable. A country that raises the rate of interest to attract foreign capital is at the same time cutting off finance for certain marginal projects as their productivity is no longer sufficient to pay the now higher interest and leave the normal profits of enterprise. (It is also making life more difficult for farmers and homeowners who must pay a higher mortgage). Profit-sharing, especially when the ratios in which sharing takes place is largely left to the market forces, can enable marginal projects to survive, which is better than resources lying idle because their use does not promise a profit higher than the rate of interest.

Conclusions

In this chapter we have shown that an interest-free financial system will be more stable than the present system. One of the reasons is synchronization between payment obligations of financial intermediaries and their revenue

accruals. As most of the liabilities of an Islamic system of banking are not fixed, it has a far greater ability to absorb real shocks to the economy than the current system. A switch over from interest to profit-sharing as the basis of financing would increase the efficiency of the economy by making productivity the basis for allocation of resources. Abolition of interest will also remove one of the main reasons for the increasing inequality in the distribution of income and wealth. An interest-free Islamic system of financial intermediation will be more just and fair. This will make it more conducive to growth and development as all members of society will be assured of a fair treatment.

CHAPTER 5

MEETING SPECIAL NEEDS

Government Finance, Financing the Consumer, Microfinance and Finance for Muslim Minorities

In this chapter we discuss how contemporary Islamic finance is meeting the needs of consumers. We discuss financing house mortgages, consumer durables and credit cards. We also focus on rural finances, how to finance the needs of agriculture. Then we move to the public sector and examine some of the financial instruments designed for mobilizing resources for public sector projects. Meeting budget deficits comes next. We also give an overview of how Muslim minorities in many countries are arranging interest-free financing of some of their needs.

Having done that it will be time to focus attention on the variety that the application of Islamic financial principles in modern economies is presenting. We pay special attention to Malaysian innovations and the Sudanese experience in financing agriculture, after examining the older experiments in Pakistan and Iran.

Consumer Finance

Consumers need finance when their current income does not meet their current expenditure. This expenditure is of two kinds: expenditure on food, clothing, and other items needed for living, and expenditure on buying a house, a car, a refrigerator and other durable goods. Consumers who cannot meet their basic needs out of their current income can be further subdivided into those who have the ability to do so on the basis of income expected in the future or past savings temporarily inaccessible, and people without means who need social support in order to survive. A suitable way has to be found to finance those who are short of money now but they can pay later.

Can Islamic financial institutions play a role in helping consumers without means to repay? Should they? In the early days of Islamic financial movement many approved such a role. The proximity of Islamic financial

institutions to the needy and their ability to handle charitable funds if entrusted to them, made this approach look promising. Some Islamic financial institutions accepted *zakat* and *sadaqat* donations and channeled them to the poor. For some years during the nineteen eighties, Dar al-Mal al-Islami disbursed *zakat* on part of its shareholders. As of now, there are hardly any reports of Islamic financial institutions accepting *zakat* money and disbursing it. One reason may be the emergence in many parts of the world of Islam of institutions taking care of collection and disbursement of charity. Considering the convention in the financial world and the complications handling charity may introduce in the regulation and governance of Islamic financial institutions, it seems prudent to assign the function of helping the needy to not-for-profit organizations. This does not, however, preclude the possibility of interaction of Islamic banks and other for-profit institutions with *Awqaf* (endowments) and charitable institutions handling *zakat* and *sadaqat*. One can envisage Islamic banks advancing funds to those who may or may not be able to pay back, acting as agents of these not-for-profit organizations. Islamic banks are also equipped to handle the funds of *waqf* and other charities, making them grow while they await disbursement.

The second kind of consumer finance relates to houses and other durable goods that give benefits over long periods of time but need huge amounts of money to buy. These expenditures can be looked upon as investments likely to yield 'returns' spread over the entire life of the asset. This provides a basis for financing of consumer durables by a profit-seeking entity, a basis not available in the case of expenditures on basic needs mentioned above.

Conventional arrangements meet both needs on the basis of interest-bearing loans or credit. Leasing also forms the basis of some conventional arrangements for financing consumer durables. Islamic finance meets the first, financing basic needs, by interest-free loans *(qard hasan)* and *murabahah* or credit sales at a price higher than the spot price when paid in cash. In financing housing and other consumer durables, varieties of *murabahah*, rent sharing and leasing-cum-sale are being used.

Islamic Modes of House Finance

Basically there are three ways a consumer could buy a house, assuming he/she cannot pay the price in cash: buy the house on credit, at a price higher than spot price, to be paid in installments over time; buy the house in partnership with a financier, buying out the financier's share over time; and get

the house on long lease, rent being fixed in a way the ownership of the house is transferred to the lessee at the end of the lease period, against a nominal payment or, sometime, as a gift. There is a fourth way too. A cooperative is formed to which members contribute enough money per head per period to buy one house each period. To which member the house goes is decided by lottery. Every member continues to pay his or her part till all members get a house. The arrangement may suit small well-knit groups but there is hardly any need to discuss it as, strictly speaking, no 'financing' is involved.

Murabahah is applied to houses that are already built. But a house may actually be built after the customer makes a down payment and signs a contract to buy the house, when built, at a certain price. This is *istisna*' (manufacture on order) applied to housing.

It generally takes the customer many years, sometime twenty to thirty years, to pay up for a house. As the total price is fixed in the beginning, with no possibility of changing it later, the seller runs a great risk, especially in a period of rising prices (falling value of currency). But it has the advantage of being the simplest of the three, with no need of repeated assessments of the market value of the house or its rent. Should a default occur *murabaha*-financing appears to be superior to conventional interest based financing. 'It would save the bank some portion of the legal costs currently spent on repossession from recalcitrant consumers and resale, since they would have the title to the assets.' (Zaman & Zaman, 2001, p. 118).

Attempts are being made to introduce a measure of flexibility in *murabahah* home finance. One recent example seems to be the terms offered by the Hong Kong Shanghai Banking Corporation (HSBC) [http://www.amanahfinance. hsbc.com].

Lease ending in ownership gives the seller the advantage of keeping the property under its ownership until the price is fully paid. This method was successfully applied for staff housing by Jordan Islamic Bank (Yahya, 1995, p.91). There are still some controversies surrounding its validity in Islamic law (Islamic Fiqh Academy, 2000, pp. 253-55). The method is not as popular in financing houses as it is for financing other consumer durables.

The most common method of house finance in Islamic framework is decreasing partnership (*musharakah mutanaqisah*). A housing unit of the

customer's choice is acquired under the joint ownership of the customer and the financier, their shares being in proportion to the money each puts in, say 20% and 80% respectively. Each one is entitled to its share in the rent as assessed in the market. The customer undertakes to buy out the financier's share by making regular monthly payments, generally equal to the monthly rent as assessed. With each payment the customer's share in the property increases and that of the financier decreases. Their shares in the rent as assessed also change accordingly. A time comes when the customer owns the entire property, the financier being no longer entitled to any portion of the rent. It will be noted that the financier will, by that time, have recovered the money it spent in buying its share of the property as well as earned some profit in the form of its share of rent paid to it as long as it retained ownership of any portion of the property. In countries like the United States where the property cannot be registered as jointly owned by the financier and the customer, it is registered in the name of the customer but the financier keeps a lien on it. The method and periodicity of assessing the monthly rent may differ from one Islamic financial institution to another but the essentials remain the same as described by us. As rising prices will, generally speaking, be reflected in the rent as assessed, this method protects the financiers against inflation by providing for a variable return to its investment. Even then it is problematic if the period allowed for payments is very long.

This is the model on which the Islamic Cooperative Housing Corporation of Canada has been operating for the last two decades (Nasim, 1998; 1999). The Muslim Savings and Investments (MSI) and LARIBA (http://www.lariba.com) follow slightly different models. In Iran *musharakah* and *murabahah* are the main modes of financing houses (Yasseri, 2002, pp. 157-58).

In conventional finance, some of the problems involved in private sector financing of houses have been solved by securitisation. Securitisation enables financial institutions to unlock the resources invested in the housing sector for further investment. This presumes the existence of developed financial markets not available in most developing countries, the group to which most Islamic countries belong. Malaysia is one of the few countries with Islamic financial institutions that are experimenting with this technique. But its Cagamas *Mudarabah* Bonds remain controversial as they involve sale of debt (Ahmad and Khan, 1997, pp. 344-45 and pp. 354-57; Ahmad, 1997b, pp. 69-72). According to mainstream Islamic finance, securitization of *murabahah* based

financial assets is not valid as it involves selling debt. Financial assets based on *musharakah* are nearer liquidity than debts.

Financing consumer durables other than houses has also taken the same course. Islamic financial institutions are financing acquisition of motor vehicles and other durable goods mostly on *murabahah* or leasing basis (Abdul-Rahman and Abdelaaty, 2002, p. 218).

Credit Cards

Many Islamic banks have issued debit cards to their customers against their accounts. Some are also offering visa credit cards with all the usual facilities. No interest can be charged on any outstanding balance, but the issuing bank is entitled to fees and commission on purchases. The *shariah* basis is provided by a resolution of the Islamic Fiqh Academy (Islamic Fiqh Academy, 2000, pp.249-50). But further innovation goes on (http://www.bankislam.com.my).

Financing Agriculture

The oldest Islamic methods for financing the agricultural sector are *muzara'ah*/*musaqat*, based on product sharing, and *salam* or advance payment for deliveries in future. *Mudarabah*, which is sharing in surplus over cost, is also applicable. *Salam* is being used in Sudan (Ahmad, 1998, pp. 57-74; Bunk al-Sudan, 2001 p. 41). Sudanese banks are also practicing *musharakah* in financing agriculture (Khaleefa, 1993, pp. 43-46; Ahmed, 1994, pp. 32-33). Practice of *musaqat* is also reported (Khaleefa, 1993, pp. 45-46). The Iranian Law of 1983 emphasized *muzara'ah* and *musaqat* (Bank Markazi, Article 17). The Iranian banks offer *qard hasan* (interest-free loans) at nominal service charges to the agricultural sector. Microfinance for cottage industries and other enterprises is being successfully arranged by Bank *Muamalat* in Indonesia. Microfinance is also being provided on the basis of *murabahah*/ *bay'mua'jjal*/installment sales in Bangladesh (Hassan, 2002, pp.137-38).

Government Finance

A modern government's financial needs are of three kinds. It needs money for activities that do not produce marketable wealth, like police, judiciary, defense and bureaucracy. It also reserves for itself some strategic

industries like nuclear energy. In between there are a host of activities resulting in essential services such as education and health care in whose production it does participate in one way or other. The first category should, in principle, be financed by taxes. For the other two it can mobilize financial resources through the market in form of prices and fees. But in practice most governments need many more resources than they can possibly mobilize through these means, at least in the short run. The reasons are many into which we need not go here. Besides, developing countries also need to mobilize resources for developmental projects the private sector fails to take up. Our purpose in raising this issue is rather limited to demonstrating that the absence of interest does not work to the disadvantage of society, insofar as financing the government is concerned. On the contrary, abolishing interest introduces a kind of discipline in government finances missing from the conventional paradigm.

It is easy to see that what governments acquire, in conventional finance, through borrowed money can also be acquired through relevant Islamic modes of finance like *murabahah* or leasing. The difference is, they get the commodity they need, not cash with which they can do what they like. But the discipline does not end here. The financier who delivers the needed commodity to the government is entitled to the price or rent contracted for. Postponement of payment does not increase the financier's entitlement. The financier's interest would, therefore, require ensuring that the government being so financed would be in a position to make good on its promise to pay at the time agreed upon. That, in most cases, requires making sure the developmental project for which the commodity is acquired on deferred payment is sound and well managed. Whether applied to domestic financiers or foreign, that is a world of change from what has been happening with the developing countries under the regime of interest-based lending during the last five decades.

A modern government also needs short-term finance to bridge the gap between expenditures to be made on a regular, almost daily basis and revenues whose collection may not be as regular. This is presently done by selling treasury bonds, or borrowing from the public (through the financial sector). Since few would lend without a return, except maybe in hours of a national crisis, a significant role can hardly be envisaged for borrowing as a means of bridge finance or for meeting budget deficit, in the framework of Islamic finance. Hence, the question to be answered is, what are the alternatives to public borrowing?

We have already provided the general answer above: The Islamic alternative to borrowing is buying the needed goods and services on credit. *Murabahah*/*bay'mu'ajjal*/installment purchase and *salam*/*istisna*' provide the legal contractual bases of doing so. But they do envisage a measure of discipline. It is no longer a relation between a creditor and a debtor, supposedly always able to pay with money it can create. It is a relation between a seller and a buyer. The seller could even demand a collateral, or keep a lien on the commodity sold on credit. As we shall note below, some governments in the countries practicing Islamic finance are able to find ways to motivate savers to lend to the government without promising them a predetermined contractual return to the loans. But the net result of a switch over to Islamic finance in the public sector would be a disciplined budget that must justify any credit transaction by producing visible results.

Developmental expenditures can be handled by using some of the well known Islamic financial instruments. These are generally based on sharing, either something actual that can be measured, or something hypothetical that can be, at best, estimated. As noted above, sharing actual returns applies to cases where the activity being financed results in a marketable product. Transportation provides a good example. When a government applies financial instruments based on *murabahah* and/or leasing, it results in the government owing a debt to the private sector. These may be applied to government financing its acquisition of industrial products from their private manufacturers. Still other instruments, based on *salam*/*istisna*, call for a combination with sharing modes involving a number of parties. There is no end to innovative combinations of sharing and non-sharing modes of Islamic finance designed to meet public sector financial needs. (Ahmad and Khan, 1997, pp. 97-127; 133-62; 231-41; 249-62; 285-306; 317-24 and 337-49; Khan, 1997).

There are responsibilities a modern government must discharge but whose returns show up only indirectly and are often not measurable. Financial instruments have been designed whose returns could be linked to the average rate of profits in the private sector of the economy as a whole, rather than to the returns in any particular industry or industries (Nadeemul Haq and Mirakhor, 1999). The Islamic Republic of Iran uses such an instrument to meet its budgetary needs. Sudan on the other hand relies on an instrument whose returns are linked to the actual returns in a group of industries in which government is a part owner. Malaysia relies on Government Investment Issues, GII. (Sundrarajan, et al, 1998, p. 7)

Easy availability of loans has lured governments in many developing countries into launching ill-conceived 'developmental' projects, even engaging in lavish non-productive expenditures. There have been lenders more eager to lend than the borrowing governments were keen to borrow. The fiction of sovereign loans led to the accumulation of debts worth trillions of dollars before the racket stopped. This could not possibly have happened if interest-based borrowing was absent from the scene. No financier would stake resources in unproductive ventures insofar as sharing-based modes of financing are concerned. When it comes to *murabahah*, leasing and other debt creating modes of Islamic finance, the fact that the resulting debt cannot be rolled over makes it unattractive to professional lenders. Also, most of the debts created by Islamic modes are non-marketable. In any case, their quality varies from debt to debt, making it costly to evaluate them. It would be reasonable to assume that the supply of finance on the basis of *murabahah* will be much less than that on the basis of interest, assuming equal rates of return on capital (i.e. the rate of mark-up in *murabahah* equals the market rate of interest).

As regards the demand for *murabahah*-based finance, it should also be lower than the demand for interest-based loans, assuming equal costs. The reason lies in the government's inability to get cash through *murabahah*-finance.[8] A government using *murabahah* or leasing to acquire real resources must use these resources to produce wealth out of which the resulting debts could be paid off. That implies a project to project, or, at the most, industry-wise calculation of costs and benefits. In a democratic government these methods of financing will contribute towards greater transparency and will lead to greater accountability.

Salam/*istisna*' have been suggested as bases of government raising cash to meet budget deficits (Kahf, 1997c, pp. 48-49; Ahmad and Khan, 1997, pp. 231-41). An obvious candidate for using this instrument is a petrol producing country. Other countries endowed with minerals or raw materials can also use it. The feature distinguishing it from borrowing on interest is the responsibility associated with the commitment to deliver the commodity involved.

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[8] Here as elsewhere in this section, *murabahah*-finance stands for all sale-based modes of financing in which the party so financed gets commodities, not cash. It thereby incurs an obligation to pay cash to the financier at a future date. The only sale-based mode of financing which can enable a government to get cash from financiers is *salam*/*istisna*' which entails the obligation of delivering a commodity at some future date.

The modes of financing preferred by Islamic economists are those based on sharing: *Musharakah*, *mudarabah*, *muzara'ah* and *musaqat*. Above we have referred to writings outlining the ways to do so. As mentioned in Chapter 3 above, Sudan recently launched Government *Musharakah* Certificates (GMC, or *shahamah*) to mobilize cash for investment in a group of public sector industries. The government guarantees the repurchase of these certificates at their face value. Profits are distributed annually. Bahrain is marketing *sukuk* based on *salam* and *ijarah*. Malaysia has a whole range of financial papers qualified for this purpose. Pakistan is trying some participatory financial instruments. With most of the financial sector nationalized, Iran's main instrument for mobilizing private savings for public sector projects are bank deposits already discussed above. Iran has recently introduced participation papers whose returns are linked to the social rates of return to public sector projects. (Nadeemul Haq and Mirakhor, 1999, pp.29-31; Sundrarajan, et al, 1998, p. 10).

Deficit Financing

Is it permissible for the government to finance some of its expenditures by printing currency notes? Is it desirable to do so? Under what circumstances could it be done? Since inflationary finance amounts to a general tax on each and every one who holds some cash, even the poorest ones, it is considered to be inequitable. Islamic economists always looked unfavourably at deficit financing (Chapra, 2000, pp. 340-42). They would allow it only in special circumstances. Sometimes the government may simply run out of all other options. Deficit financing in such a situation would be characterized as a necessity (*darurah*) and allowed as a temporary measure, to the extent necessary.

Muslim Minorities and Islamic Finance

One out of every three Muslims in the world lives in a country where the majority does not share his/her faith. Yet Muslims living as minorities are as keen to avoid *riba*/interest as other Muslims anywhere else. They have found three ways to satisfy this urge: Establishing interest-free non-banking financial institutions within the framework of the laws of the land; getting issued a special law by the state enabling them to establish an interest-free Islamic bank; and utilizing the services of foreign banks and Islamic financial institutions offering Islamic products. There have also been examples of unregistered

saving and loan societies and investment companies claiming to be working in accordance with Islamic law, but they generally belong to the past. It is now generally recognized that in order to be trusted with people's savings, an institution must work within the supervisory and regulatory framework of the country in whose jurisdiction it is operating.

The Philippines is the first country which gave its Muslim minority a financial institution operating, partially at least, in accordance with Islamic law. The Philippines Amanah Bank was established in 1973 (Mastura, 1988). It was directed at the special developmental needs of Muslims in Southern Philippines. But only the Pilgrims Special Savings Deposit Accounts are free of interest, based as they are on PLS (profit and loss sharing). In the 1997 Directory of Islamic Banks and Financial Institutions it is listed as Al-Amanah Islamic Investment Bank of Philippines (IAIB, n.d., p. 21). Thailand Muslims have been struggling to establish some rudimentary financial institutions since the Nineteen-eighties (Pitsuwan, 1988). As already noted in Chapter 3 they now have a number of financial institutions offering Islamic products as well as an Islamic bank. (Islamic Banker, 2002, p. 27)

South Africa, with a Muslim population of about 3%, has more than one Islamic financial institution, including the Al-Barakah Bank. (Moore, 1995, pp.222-25; Kamel, 1992, p. 331-32)

India has hundreds of non-bank Islamic financial institutions (Bagsiraj, 2002). Most of these are small saving and loan societies. But there are also mutual funds dealing with huge amounts of money. Some institutions also offer funds for investment. There are a few institutions providing finance for building or buying a house (Abdul Ahad, 1995). A subsidiary of Jeddah based Dallah Al-Barakah is also operating in this field (Moore, 1997, p. 213; Kamel, 1992, pp.332-33). Big Islamic financial institutions are required to be registered under Non Banking Finance Companies RBI Amendment Act 1997. Sri Lanka too has an Islamic Bank. (IIBI, 1995, p 370)

In the United States, Europe and other western countries some major financial institutions are now offering Islamic products. But there are also small Muslim managed institutions, including MSI and LA*RIBA* in the US, already noted above, providing finance for housing, motor vehicles and other durable consumer goods. Islamic insurance is also available. A number of credit unions are also functioning in different parts of United States. In the Caribbeans we

have the Muslim Credit Union in Trinidad. Australia has the Muslim Community Cooperative Association. Attempts are underway to establish an Islamic bank in London, a city that already hosts a number of Islamic funds, investment companies and other non-bank Islamic financial institutions. (Moor, 1997, pp. 227-34)

Not much is known about China. Al-Barakah did open an office in Ningxia (Kamel, 1993, p.334). The Ningxia Islamic International Trust & Investment Corporation established 1985 is serving the Hui region. (http://www. iitic.com/niitic_english.htm).

There have been several attempts to open Islamic banks in the Russian Federation, including those by the Al-Barakah group (Kamel, 1993, p. 334). Now we have the Badr-Forte Bank that 'operates on interest-free finance and partnership (profit and loss sharing) principles' (www.forte-bank.ru). They have correspondent relations with several Islamic banks including those in Indonesia.

Conclusions

Above we have seen how Islamic financial instruments based on contracts discussed in classical *fiqh* can replace interest-based lending and borrowing in various sectors of a modern economy. Consumers can buy on credit. Home ownership can be facilitated in a number of ways. Agriculture can get the needed finance on the basis of sharing or advance sale of crops. Government's non-developmental expenditures are subjected to more discipline than in conventional finance. But they do get what they need as demonstrated by a number of modern governments practicing Islamic finance. Muslim minorities are able to meet some of their financing needs through non-bank Islamic financial institutions established by them. Some of these, like those in South Africa, have their own Islamic banks. Other countries, including the United Kingdom, may soon follow suit.

CHAPTER 6

MONETARY MANAGEMENT, INFLATION AND INDEXATION

We have now a fairly clear picture of how a modern economy works in the framework of interest-free Islamic finance. We can complete the picture by considering circumstances calling for special measures to ensure smooth functioning of the economy with justice and equity. What needs being done to avoid fluctuations in the value of money, especially to prevent inflation? And what measures the monetary authorities can take to restore normalcy should inflation occur? Is indexation of wages called for? What about indexation of loans, especially of debts arising from credit transactions such as *murabahah*?

Adequate literature is available on monetary management in an interest-free Islamic economy (Uzair, 1982; Ariff, 1982; Al-Jarhi, 1983; Chapra, 1985a, pp.187-214; Khan and Mirakhor 1987, pp. 161-84; Khan and Mirakhor, 1994; Choudhry and Mirakhor, 1997; Sundararajan, Marston and Shabsigh, 1998). Islamic economists have argued that all the tools of monetary management available in conventional finance are also available in Islamic finance, with the sole exception of the bank rate (or the discount rate used by the Federal Reserve Bank in the United States of America). The non-availability of the rate of interest on which the central bank lends to the commercial banks or borrows from the public (by selling treasury bonds) as an instrument of monetary policy, is, however, not seen as a disadvantage. There are basically two reasons why the bank rate is not important: it has proved not be a very effective policy instrument, especially in the developing countries, and, secondly, Islamic finance provides alternatives that could be used in its place.

As an alternative to bank rate as an instrument of monetary policy, we have two new variables in an interest-free Islamic financial system: the rates of mark-up in sales with deferred payment, and the ratios in which sharing between financier and fund-user takes place in sharing modes of financing. These ratios provide a means of manipulating the effective rates of profit accruing to the financiers and the depositors, respectively. The first best is to leave these variables to the market, to be determined by the forces of supply and demand. But it is possible to use them as policy instruments. As a matter of fact,

all three countries adopting Islamic finance officially, Iran, Sudan and Pakistan authorize the monetary authority to regulate these variables in public interest (Bank Markazi, 1983, article 20 b; Wizaratul 'Adl [Sudan], 1996, p. 152 and p. 162 [clauses 20 and 36 of the 1993 law]; State Bank of Pakistan, 1985, pp. 24-26). The theory of Islamic finance shows how that could be possible (Siddiqi, 1983b, pp. 97-123; Uzair, 1982). The desirability of doing so has, however, been controversial. (Ahmed, 2001; Ariff, 1982a, pp. 14-15)

The banking laws of the three countries trying to manage their financial sectors in accordance with Islamic principles, Iran, Sudan and Pakistan, have given their central banks the power to regulate the rates of profits expected from commercial banks' financing (Bank Markazi, 1983, Article 20 b; Wizaratul 'Adl [Sudan], 1996, pp. 152, 162 [clauses 20 and 36 of the 1993 law; State Bank of Pakistan, 1985, pp. 24-26). The Iranian laws and bylaws provide for a Minimum Anticipated Rate of Return (MARR) as a yardstick by which to judge the acceptability of credit applications to banks. But the same rate can also be used as an instrument of monetary policy serving the same purpose as the rate of interest (IIBI, 1995, pp. 226-27). Iranian laws and bylaws also provide for a Maximum Rate of Profit (MRP) as the upper limit for mark-up in *murabahah* financing. Determined from time to time by the monetary authorities, this rate also becomes an instrument of monetary policy serving the same purpose as the rate of interest in conventional banking (IIBI, 1995, p. 227) Similar provisions are available in the relevant Sudanese and Pakistani rules mentioned above.

Regulation and Governance

Supervision and regulation of Islamic financial institutions has been receiving greater attention since the 1990s. Besides the present in-house *shariah* advisors serving these institutions, there is a call for 'centralized *shariah* board' and independent 'chartered *shariah* auditors' and other 'shared' institutions (Chapra and Ahmed, 2002, pp. 79-84). The AAOIFI is playing the leading role in this regard. Besides dealing with accounting and audit, it has also laid down certain standards for governance of Islamic financial institutions. (AAOIFI, 2002)

Monetary management of a country can no longer be conceived in terms of national institutions only. With the increasing integration of world financial markets, interaction with the relevant international agencies has become a must. Countries adopting Islamic finance at the official level are not facing any

problems doing so. Islamic financial institutions have same legal and regulatory obligations as traditional banks and they discharge these obligations efficiently. (Chapra and Ahmed, 2002, pp. 73-77; Chapra and Khan, 2000, pp. 17-25)

Inflation

An Islamic economy is seen not so vulnerable to price fluctuation as the conventional economy. Because of prohibition of interest, lending as a mode of finance no longer remains popular. Hence, even taking into account the debt creating Islamic modes of financing, an Islamic economy would generate a smaller volume of debt, other things remaining the same. Due to this and due to the absence of interest rates, an Islamic economy leaves far less scope for speculation than the conventional economy. Also, the way new money is created in an interest-free Islamic economy, keeps the supply of money tied to the supply of goods and services. Islamic economists also point out to the built-in stabilizers in the fiscal system of Islam. (Khan, 1980; 1982, pp. 238-51, Faridi, 1983, p.44)

It cannot be denied, however, that an inflationary situation could arise in an Islamic economy. One possible source of an inflationary pressure could be exogenous, triggered by inflow of foreign money, for example. Another reason could be mismanagement on part of the relevant authorities, whether politically motivated or inadvertent. That includes deficit financing of a kind not permissible in an interest-free system in which borrowing ceases to be a mode of financing the government .The question we need to answer in the context of this study is: how could inflation be controlled and price stability restored in an interest-free Islamic economy?

To control inflation the supply of money need to be curtailed. The conventional tools of policy for doing so are open market operations, raising the rate of interest at which the financial sector can get cash from the central bank, increasing the reserve ratio, increasing margin (down payment) requirements on installment sales, letters of credit, etc., and direct controls. To control inflation in an interest-free Islamic economy, the ratio of profit-sharing between banks and depositors can be decreased (i.e. changed in favor of banks). This would curb the supply of money by decreasing the supply of savings into investment accounts, thereby affecting the ability of banks to supply funds to business. Increasing the ratio of profit-sharing between banks and business (i.e. changing

it in favor of banks) will curb the demand for money by business. [Siddiqi, 1983b, p. 101 and p.122]

For open market operations, the monetary authority in an interest-free Islamic economy can use securities other than interest bearing bonds or treasury bills. These financial papers could be based on rent sharing (in leasing) or profit-sharing (in manufacture or trade). As we have seen earlier, Sudan has launched Government *Musharakah* Certificates (GMC, called *shahamah* in Arabic) and Central Bank *Musharakah* Certificates (CMC, called *shamam* in Arabic). Iran has its own version of participation papers. (Nadeemul Haq and Mirakhor, 1999, pp. 29-31)

Monetary authority in an Islamic system would also be able to use reserve ratios and direct controls as the authorities in the conventional system do. All other non-interest tools will also be available. Monetary authorities in the Islamic Republic of Iran have been successfully using 'open market operations (outright sale of central bank participation papers), change in reserve requirements,..' and other tools for controlling the money supply (Komijani, 2003, p.6). If these instruments prove insufficient to bring inflation under control, supply of funds to business could be influenced with a view to decreasing the volume of investment. This would require changing the ratio in which the financiers share the profits of their business partners so that business gets a smaller portion than before. This will effectively cut off funds to some marginal projects by reducing the rate of profit percent on capital invested in business, thereby decreasing the demand. It may also increase the volume of savings by effectively raising the percentage rate of profits on money deposited into investment accounts. As banks get more from business they would distribute more to depositors, the ratio of profit-sharing between banks and depositors remaining the same. If need be, the authorities could change that ratio too, obliging the financial intermediaries to give a larger portion out of the profits accruing to them. That will reinforce the tendency of savings to increase, causing consumer demand to decline. Doing this may become necessary in a situation of demand-induced inflation.

Sometime the authorities specify a certain minimum of expected profit from a project for that project to be qualified for being financed by a bank on the basis of profit-sharing. This may be done basically for preventing money deposited by savers to be invested in ill-conceived projects. But once there, this variable, the minimum qualifying expected rate of profit, can be raised or

lowered to decrease or increase the volume of investment. The MARR determined from time to time by the monetary authorities in Iran serves this purpose. As we have noted above, the Pakistani and Sudanese central banks also enjoy this power. (State Bank of Pakistan, 1985, pp 24-26; Wizaratul 'Adl [Sudan], 1996)

Regulating the rate of mark-up, the profit margin added to the purchase price, in case of installment sale/*bay'bi thaman aajil*/*murabahah* is not desirable in normal circumstances. It will naturally differ from market to market, even customer to customer, depending on the time factor and the financiers' perception of the risks involved. But the authorities may sometime feel obliged to fix a ceiling, as provided in the Iranian case. Once it is there, lowering the maximum rate of profit that sellers are allowed to add in cost-plus financing will effectively choke off some investment. Keeping in view the fact that new money in an Islamic economy is created through investment activities more than through lending, it amounts to curtailing the supply of money.

Indexation

Whatever is done, it is not always possible to keep the price level stable. During the post-World War II period, that is the last sixty years or so, the world economy has experienced bouts of instability that hardly any country could escape. With increasing financial integration between world markets, an isolationist policy has become impossible. Small, weak economies of South Asia and Africa, and to a lesser degree the economies of South America and South East Asia, have been especially vulnerable. With majority of personal incomes, particularly wages, barely above survival levels, a continuous erosion in the purchasing power of the local currency caused by inflation soon becomes unbearable. Inflation also adversely affects long-term financing of industrial projects. Investment suffers a setback not only because of the real returns falling, but also because of the uncertainties it creates. Savings decline in consequence of falling real incomes and reduced real returns to deposits.

Fighting inflation, at least keeping it within limits, say below 5 percent per year, may be regarded as a universally acclaimed goal. It has more importance for an interest-free system. Interest rates always rise in an inflationary situation. Even though they do not supply adequate relief they do compensate the lenders to some extent for the erosion in the value of the currency. An Islamic economy does not rely on loans insofar as business is

concerned. But it does envision a role for *qard hasan,* which are loans without interest, in financing personal consumption and government expenditure in case of emergency (Siddiqi, 1983a, pp. 142-52). If inflation is fast eroding the value of money the supply of interest-free loans is bound to decrease as people take steps to protect their savings, like buying gold or real estate, etc. It is imperative, therefore, not to allow more than mild inflation in an interest-free Islamic economy.

Stability in the value of money is not easy to achieve, especially for the developing countries. The problem is that many measures required for curbing inflation, like decreasing government expenditure, increasing taxes and tightening bank credits, tend to lower demand, decrease investment, create unemployment and lower production thereby frustrating the efforts at development.

Faced with this situation, many countries were obliged to protect the real incomes of at least a section of their population by raising their nominal incomes in the wake of a rise in price level as measured by consumer price index. But this led to a rise in nominal costs causing the price level to rise further. Then the authorities were obliged to take a number of other measures in order to contain the situation and preventing a wage-price spiral from developing.

Indexation was a hot topic in Islamic financial circles during the nineteen-eighties (Siddiqi, 1983b, 41-44; Kahf, 2000) when the bad effects of the double digit inflation since the seventies had started creating pressures for indexation of loans, debts resulting from credit sales and financial obligations arising out of other transactions. The situation changed in the nineteen nineties when inflation was tamed in the developed world and returned to single digits in much of the developing world. In conventional finance a rise in the nominal rates of interest that accompanies inflation is supposed to take care of the problem, though partially, insofar as debts are concerned. Many felt Islamic finance required some special measures to solve the problem in view of its interest-free nature.

Wage indexation did not pose much of a problem from *shariah* point of view (Islamic Fiqh Academy, 2000, p.162). Wages and salaries are prices, not debts. The price could be moved up to compensate for the erosion in the purchasing power of the currency in which wages were specified. A provision

to this effect could be built into the wage contract itself. As long as the rise in price level could be measured by a responsible agency like the state, there was no dispute-causing *gharar* involved in a contract that included such a provision. Also, it did not amount to placing a burden on the employer as the extra money paid due to indexation of wages was going to become part of the costs and passed on to the buyers of the products concerned. Rents too could be treated in a similar manner, especially when the lease was to cover a long period of time (Islamic Fiqh Academy, 2000, p. 264). Indexation of wages and rents is no doubt beset with many problems. The results of its widespread practice in a number of South American countries do not encourage repeating the same experiment elsewhere. The issue, however, was no longer of permissibility but desirability: whether it did more good than harm, an issue of *maslahah*. But the same is not true of indexation of debts, for a number of reasons.

The most important reason seems to be not technical but moral: whom to oblige to compensate for the erosion in purchasing power of the currency in which the debt is contracted? The usual answer, let it be the debtor, is not very convincing. It is not certain that the debtor can pass on the additional burden to someone else, as was possible in case of indexation of wages noted above. It is certainly not possible to do so in case of debts related to consumers.

The moral case for compensating the creditor is not very strong in case of debts created by credit sales, as the deferred price would contain a mark-up in view of the anticipated inflation.

Leaving aside debts owed by the consumers and debts owed to sellers on credit, there remain the loans made in cash and obligations to pay arising from transactions of a long-term nature. The former would, in an Islamic economy, normally include only *qard hasan*, interest-free loans. Whether made to individuals, voluntary institutions or government. Is there a moral case for these lenders (who cannot claim interest) to be compensated for the loss in the purchasing power of what they gave? One can say that giving a loan without a return is an act of charity, as the giver is voluntarily giving away the benefits of owning the money for a time without a *quid pro quo*. The loss the giver sustains due to erosion in the purchasing power of the currency should be regarded as an additional charity. This is acceptable as long as the rate of inflation is low. But to expect a steady supply of interest-free loans in face of double-digit inflation is unrealistic. Above we have seen that it will not be good for the health of an

Islamic economy if the supply of interest-free loans dries up as we fear will happen in severe inflationary situations. (Also see, Iqbal, 2000, pp. 88-96)

Regarding transactions involving payment after very long periods of time, it can be said that a margin to cover the anticipated inflation could, like other credit deals noted above, be built into the contract defining the future entitlement. That would mean no special provision is needed to protect the interests of the entitled person. Exceptions, however, are possible.

That brings forth the case of currencies whose values have suffered an excessive erosion or almost total collapse. Scholars agree that obligation to pay denominated in these currencies need to be reassessed. It is reassessed in terms of the 'value' of the currency at the time of contract or at the point of time just before the collapse in its value took place (Kahf, 2000, p. 274, no. 7). The solution can hardly be regarded as an ideal one in view of the fact that it is more considerate to the receiving party than to the one required to pay up. But the more important aspect of the solution is that it is based more on considerations of equity, i.e. *maslahah*, than on justice in exchange, based on reciprocity and equivalence. It is rightfully thought that it will be a kind of *zulm* (injustice) to pay to the one entitled something, which can buy only a tenth of what it could have bought if it were paid earlier. This, however, does not ensure that asking the other party to pay ten times the nominal amount due does not constitute an additional burden on him/her. After all, the collapse in the value of currency is not his or her doing. The time and labor required to earn the new amount due, i.e., ten times what was due in the old currency, may be much more than was required to make the original sum at the time of contract. But these genuine concerns are over-ruled in order to protect the other party, often construed to be the weaker one, from a greater harm. One could invoke a number of legal maxims[9] in support of such a solution, like:

> Damage (*darar*) shall be removed (20).
> Severe damage may be removed by doing a lighter damage (27).
> Damage shall be removed to the extent possible (31).

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9 These maxims are taken from the Ottoman Majallah compiled between 1869 and 1876. The numbers in parentheses that follow the texts correspond to the number of clauses in the Majallah. For an English translation of the Majallah see: C. R.Tyser, The Majelle, Lahore, Law Publishing Company,1980.

> When there is (unavoidable) choice between two bads (*mafsadah*), remedy of the greater one is sought by choosing (to do) the smaller one (28).
> (If necessary) the lesser of the two evils will be chosen (29).

It may be noted that protecting the value of *qard hasan* (interest-free loan) is not a case of reciprocal justice or equivalence between what was paid and what is paid back. Some Islamic economists have argued for indexing interest-free loans (Ariff, 1982, p. 177). The problem is how to ensure the continuity of a practice which involves vital public interest *(maslaha 'aamah*), and which is threatened by excessive fall in the value of the currency. It is obvious that the problem does not arise from any act of the borrower. It may have come from the system, caused by forces beyond the power of the lender or the borrower to control. Justice does not demand that the borrower be obliged to compensate the lender for the loss in the value of the loan. However, it is necessary to protect the lenders for reasons noted above.

Since we have a clear case of public interest (*maslahah 'aammah*) it requires a decision based on public policy (*siyasah shar'iyah*)--- dealing with matters of policy in a manner that will best serve the interests of Islam and Muslims. One has to distinguish between loans made to government and loans made to individuals. It would be appropriate for the government to find a way to protect the lenders (free of interest) against excessive erosion in the value of their entitlements at the time of repayment. In the case of personal interest-free loans, those being repaid after a long period of time could be categorized with the case of collapse in currency values noted above. Those being paid after smaller periods can be left to the goodwill of the borrower. There is no bar on an addition to the sum originally borrowed, being made voluntarily by the borrower. The Prophet himself is reported to have paid back a loan with something added. (Abu Daud, *kitab al buyu', bab fi husn al-Qada*, *hadith* number 3347)

Once it is recognized that the issue of protecting the value of certain categories of interest-free loans belongs to public policy (*siyasah shariah*), protection can also be extended to some cases other than those noted above: Retirees, people above a certain age, widows and those surviving on what remains of their life-savings deserve special consideration. Government can issue indexed bonds available only to such persons, thus protecting their savings against inflation. The nominal excess payment made by the government to the

bearer of the bond at the time of its liquidation could be construed as compensation for damages, though un-intended, caused largely by government's failure to control inflation. In addition, it can also be construed as a grant to one deserving a grant, the ownership of the bond being made a means to identify the deserving.

Conclusions

This chapter has shown that almost all the conventional tools for monetary management will be available in the Islamic framework also. In place of bank rate, the authorities would be able to manipulate the ratios of profit-sharing and the rates of mark-up, if needed. An Islamic economy will be less prone to inflation as compared to conventional one, other things remaining the same. Should it be deemed necessary, indexation of wages does not pose any problem, insofar as its permissibility is concerned. But indexation of loans is not advisable for a number of reasons, its proximity to *riba* being one of them. However, in exceptional circumstances it will be possible to arrange for compensating the creditor/ one who is entitled to payment for loss of purchasing power of the amount contracted for. This should be seen as a matter of public policy rather than of justice in transaction.

CHAPTER 7

CONCLUSIONS AND PROSPECTS

The main conclusions of this study can now be summarized. We began with the Islamic view on life that links social relations to the relation between man and God. The *shariah* i.e. Islamic Law, aims at felicity of human beings, all of them. Justice and fairness in transactions, as well as equity and care for others are necessary for ensuring good life. Finance is an important area in which Islam seeks to ensure justice and equity.

We studied the Quranic texts that categorically prohibit *riba*, making no exception. *Riba* is bad for society as well as individual personality. Considering modern bank interest, we found that it is *riba*. Prohibition of *riba*/bank interest aims at preventing injustice and ensuring fairness, equity and efficiency. Drawing a parallel between profit in trade and *riba*/interest is invalid. We also found that throughout Islamic history prohibition of *riba* has been applicable to consumption loans as well as loans for productive purposes.

Financial intermediation is possible without interest. Islamic finance offers a number of ways in which funds accepted by an intermediary on the basis of profit-sharing can be profitably invested. Profit-sharing is the preferred mode for financing productive projects but modes of financing based on sale on cost-plus basis, or leasing, are also available.

In the third chapter it was shown that Islamic banks as well as non-bank Islamic financial institutions have been working well in several countries for the last three decades. A number of countries have adopted Islamic finance at the official level. Recent experience has shown that there is a wide scope for innovation in offering Islamic financial products. Efforts are being made for developing Islamic capital and money markets. Also, countries adopting interest-free Islamic system have had no problems interacting with the IMF or other international financial institutions.

Then we proceeded to demonstrate what benefits are expected from obeying the divine law prohibiting interest. Islamic finance promises greater stability than conventional finance. One of the reasons for greater stability in an

Islamic financial system is synchronization between payment obligations and revenue accruals. Another reason is that there will be far less scope for unhealthy speculation in the Islamic system because of absence of the rate of interest and reduced volume of debt. This will also contribute towards stability. We observed how even the non-sharing modes of financing like *murabahah* that result in debts still keep credit creation firmly linked to the real economy.

An Islamic economy will be more favorable for entrepreneurship as it will abolish a guaranteed return to money capital even when the use of capital fails to create additional wealth. We argued that the institution of interest is the main cause behind increasing inequality in the distribution of income and wealth, within nations as well as between nations. An Islamic economy will have a more equitable distribution.

In the same chapter, dealing with the economics of Islamic finance, we argued that an interest-free Islamic economy would be more efficient than the conventional system based on interest. Funds for investment allocated on the basis of sharing modes of finance go to more productive projects rather than to more creditworthy borrowers, increasing efficiency. Also, an Islamic system largely based on profit-sharing between savers and investors would harmonize the interests of the two groups, thereby gaining in efficiency. An Islamic environment may be more conducive to growth because of greater stability, more efficient allocation of resources and a fairer distribution of wealth.

Chapter five showed how an Islamic financial system is able to meet the various financing needs of the consumers without involving interest. Houses are being financed by Islamic financial institutions on the basis of joint ownership with rent sharing, *murabahah* or lease ending in ownership. Financial instruments based on Islamic contracts have been designed to enable governments to mobilize funds for developmental projects and/or meeting budget deficits.

Lastly, it was argued that absence of the rate of interest would not cause any problems in monetary management in an Islamic economy. On the contrary the Islamic instruments for monetary management impose greater financial discipline, call for transparency and oblige governments to adhere to accounting standards. We argued that an Islamic economy would be less prone to inflation. The reason lies in the way money creation takes place in Islamic financial system and the way government is financed. Attending to the problem created

by inflation, we found that indexation of loans is not acceptable as a general policy. But certain kind of loans or payment obligations can be considered for special treatment.

Muslims living as minorities are finding ways to avoid involvement with interest by establishing non-bank interest-free financial institutions. It is being increasingly possible for them to utilize the services of Islamic financial institutions operating at the international level. Islamic finance is now spreading to all parts of the world.

Future of Islamic Finance

Three factors make this writer think Islamic finance bears great promises for the future. These promises are as relevant to Muslims as to mankind in general.

First is the growing unease about the functioning and consequences of the conventional system. Second is the resilience of Islamic finance as demonstrated by recent history. Lastly, new movements of reform in the area of money, banking and finance, especially at the international level, are giving more and more importance to moral values and social considerations, which happens to be the distinctive feature of the Islamic approach.

Regarding the unease about conventional finance, the significant point is that most if not all the worrisome aspects of the current financial system can be related to the institution of interest. Increasing volume of consumer debt, ballooning government debts, piling up of third world debts… are some examples. Asset concentration insofar as commercial banks are concerned, and difficulties faced in financing small enterprises, tend to expel bulk of humanity from the money circuit. The system creates too many fixed payment obligations, uncaring about ground realities. Add to this the growing disparities between groups within a nation as well as between various regions and groups of nations and you wonder whether increasing threats to world peace are not rooted in these conditions.

As it stands, the performance of the conventional financial system is suboptimal. The monetary and fiscal policies recommended to improve the system's efficiency are often complicated and unconvincing. The simple and

straightforward approach of Islamic economics has every chance to attract attention.

The manifold increase in GNPs and the general uplift in standards of living in most if not all parts of the world matches ill with the rising levels of anxiety caused by instability, frequent job losses and uncertainties relating to currency values and exchange rates. Many wonder if investments exclusively targeting higher profit margins, uncaring about social responsibility and moral obligations, can ever rectify the situation, which is, partly at least, its own creation. They rightfully think socially responsible investment calls for a redesigning of financial institutions. Such redesigning becomes possible once the divorce of ethics from economics, a handiwork of secular materialism, is ended. There is no reason for the moral objectives of individuals not to be reflected in their economic decisions. There is no rationale for investment decisions, even those taken by impersonal institutions operating on behalf of individuals, to be focused exclusively on private gain, unmindful of public weal. The test of our ingenuity lies in finding a way to translate this new vision of a moral society with socially responsible finance into functioning institutions.

Islamic finance has grown steadily despite its humble beginnings. The period of its expansion in the east has coincided with movements for socially responsible investment and ethical banking in some western countries. At a time when technology driven globalization is perceived hijacked by hegemonic powers adding greater woes to developing countries of Asia, Africa and South America, an innovative approach to finance rooted in the religion and tradition of the east assumes special significance. Shall the new initiative gather the critical mass to bring about a global change?

Crucial for future prospects of Islamic finance is the dedication and seriousness of purpose with which its sponsors, Muslim countries and communities, handle it in the coming decades when everything in the world, including the financial system, is going to be reshaped.

FOR ALLAH ALONE IS EVERLASTING EXISTENCE

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